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A Significant Decision For Going-Private Transactions

Law360, New York (August 22, 2013, 9:25 PM ET) -- In a decision with great potential significance for the structuring of going-private transactions, Delaware Chancellor Leo Strine recently held in *In re MFW Shareholders Litigation*[1] that a merger with a controlling stockholder would be reviewed under the highly deferential business judgment rule rather than the "entire fairness" standard if the merger is structured to include certain procedural safeguards for minority shareholders.

The Business Judgment Rule and the Entire Fairness Standard

As the Delaware Supreme Court has recognized, in litigation challenging board action, "[t]he choice of the applicable 'test' to judge director action often determines the outcome of the case." [2] Most board action — including a decision to approve a third-party merger offer — is reviewed under the business judgment rule, which precludes the court from inquiring into the fundamental fairness of the deal. Under that rule, the court must dismiss any challenge to a corporate transaction unless the terms were so disparate than no rational person in good faith could have thought the transaction was fair. [3]

One notable exception to application of the business judgment rule is judicial review of a corporation's transactions with its controlling or dominating shareholder, such as a going-private transaction. Those transactions are generally considered under the "entire fairness" standard, requiring the controlling shareholder to affirmatively demonstrate both "fair dealing" with the board and that the transaction was completed at a fair price. [4] The application of the "entire fairness" standard "normally will preclude dismissal of a complaint in a Rule 12(b)(6) motion to dismiss." [5]

The Delaware Supreme Court has held that the burden under the entire fairness doctrine will be shifted to the plaintiff challenging a transaction if the transaction was approved either by an independent special committee of the board or by the majority of the noncontrolling stockholders (i.e., a "majority-of-the-minority vote"). [6] But this shifting of the ultimate burden of proof does not change the fact that "the initial burden of establishing entire fairness rests upon the party who stands on both sides of the transaction." [7]

As a result, even with one of those procedural safeguards in place, lawsuits challenging going-private transactions generally have a low threshold to survive a motion to dismiss. And, whoever bears the burden, entire fairness review requires a fact (and discovery) intensive review of the transaction. This means that virtually any lawsuit challenging a transaction with a controlling shareholder — regardless of its merits — will have settlement value simply because there is no feasible way for defendants to get the suit dismissed on the pleadings.

In re MFW Provides for Business Judgment Deference to Going Private Transactions with Adequate Procedural Safeguards

In *In re MFW*, the Delaware Chancery Court for the first time considered the proper standard to review a going-private transaction when the controlling shareholder has conditioned the transaction on both approval by an independent special committee of the board and a majority-of-the-minority vote. In *In re MFW*, Chancellor Strine concluded that such transactions should be reviewed under the business judgment rule because “[a] transactional structure with both these protections is fundamentally different from one with only one protection.”[8]

The decision *In re MFW* has the potential to benefit both controlling and minority shareholders because it will encourage controlling shareholders to structure bids with the maximum procedural protection for the minority while allowing controlling shareholders to escape the cost and uncertainty of litigation under the entire fairness standard.

Factual Background

In re MFW involved a challenge to M&F Worldwide’s going-private transaction with its controlling shareholder, MacAndrews & Forbes, investor Ronald Perelman’s holding company. From the start of the process, MacAndrews & Forbes agreed that it would only proceed with a transaction approved both by an independent special committee of MFW’s board of directors and by a majority vote of MFW stockholders not affiliated with MacAndrews & Forbes.

MFW’s board formed a special committee which chose its own independent legal and financial advisors and met eight times over the three-month course of negotiations. The record showed that negotiations with the special committee led MacAndrews & Forbes to raise its bid \$1 per share to \$25. After the special committee approved the merger, a majority of the minority of MFW stockholders voted to approve the merger, as well.

Despite these procedural safeguards, the deal predictably spawned litigation against MacAndrews & Forbes, Perelman and MFW’s directors, alleging that the merger was unfair to minority stockholders.

The Court’s Analysis

On a motion for summary judgment, MacAndrews & Forbes argued that while a going private merger by a controlling shareholder is subject to “entire fairness” review if it is subject only to either special committee approval or majority-of-the-minority approval, a transaction that is subject to both of these procedural safeguards is functionally akin to a transaction between unrelated parties and should be entitled to the protections of the business judgment rule.

The plaintiffs responded by arguing that requiring every controlling stockholder transaction to survive entire fairness review was good for minority holders and that requiring a majority-of-the-minority vote adds little marginal value to minority shareholders beyond special committee review because long-term stockholders who oppose the transaction simply sell-out to arbitrageurs who will vote to approve the transaction to lock in their short-term gains. For that reason, the plaintiffs argued that a transaction with both safeguards should be treated the same as a transaction with only one.

In a detailed and well-reasoned opinion, Chancellor Strine agreed with the defendants. He explained that the combination of the two safeguards provides significant additional minority protection. While a special committee ensures “that there is a bargaining agent who can negotiate price and address the collective action problem facing shareholders,” a “majority of the minority vote provides stockholders a chance to vote on a merger proposed by a controller-dominated board.” As a result, in Chancellor Strine’s view, the two protections, while individually incomplete, “are complementary and effective in

tandem” and “[a] transactional structure with both these protections is fundamentally different from one with only one protection.”[9]

If controlling shareholders do not get some additional benefit from providing both of these complementary safeguards, they have no incentive to do so. Accordingly, Chancellor Strine reasoned that granting business judgment deference “would benefit minority stockholder because it will provide a strong incentive for controlling stockholders to accord minority investors the transactional structure that respected scholars believe will provide them the best protection.”[10]

Conclusion

It should be noted that the plaintiff has recently appealed Chancellor Strine’s decision in *In re MFW*. And while Chancellor Strine’s decision is cogent and well-reasoned, he acknowledged the tension on this issue in the existing Delaware Supreme Court cases law. [11]

But if the decision stands, it provides controlling shareholders a clear outline of how to avoid entire fairness review in favor of more advantageous business judgment deference. Under *In re MFW*, controlling shareholder transactions would be judged under the business judgment rule if: (1) the transaction is approved by both a special committee and a majority-of-the-minority vote; (2) the special committee is independent of the controlling shareholder; (3) the special committee has power to reject the proposal and is free to retain independent legal and financial advisors; (4) the special committee meets its duty of care; and (5) the minority vote is nonwaivable, fully informed and uncoerced.

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[1] 67 A.3d 496 (Del. Ch. 2013).

[2] *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 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”).

[3] See *Sinclair Oil Corp v. Levien*, 280 A.2d 717,720 (Del. 1971) (“A board of directors enjoys a presumption of sound business judgment, and its decision will not be disturbed if they can be attributed to any rational business purpose.”); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (“To rebut the [business judgment] rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached [their duties of] loyalty or due care. If a shareholder plaintiff fails to meet this evidentiary burden, the business judgment rule attaches to protect corporate officers and directors and the decision they make, and our courts will not second-guess these business judgments.” (internal citations omitted)). The business

judgment rule reflects the “cardinal precept of the General Corporation Law of the State of Delaware . . . that directors, rather than shareholders, manage the business and affairs of the corporation.” *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).

[4] *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 110 (Del. 1952) (a majority shareholder standing “on both sides of the transaction, . . . bear[s] the burden of establishing its entire fairness”); see also *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983); *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937 (1985).

[5] *Orman v. Cullman*, 794 A.2d 5, 20 n.36 (Del. Ch. 2002).

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

[7] *Id.*

[8] 67 A.3d at 503.

[9] *Id.*

[10] *Id.*

[11] See *id.* at 520 (noting that “there are broad statements in certain Supreme Court decisions that, if read literally and as binding holdings of law, say that the entire fairness standard applies to any merger with a controlling stockholder, regardless of the circumstances”).

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