

Delaware Court Applies Business Judgment Rule to Going-Private Merger with Controlling Stockholder

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Court of Chancery Rules that Business Judgment Rule Applies to Controlling Stockholder, Going-Private Mergers Subject Upfront to Both Special Committee Approval and Majority-of-the-Minority Vote; Possibly Sets Stage for Supreme Court to Rule Definitively

In a recent, landmark Delaware decision in *In re MFW Shareholders Litigation*, C.A. No. 6566-CS (Del. Ch. May 29, 2013), Chancellor Leo E. Strine, Jr. answered a frequently debated (but unresolved) question of whether a going-private merger with a controlling stockholder could be structured to invoke the business judgment rule, and not the entire fairness standard of review. Resolving this issue of first impression, the Court held that the business judgment rule will apply “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.”

For the past two decades, since the Delaware Supreme Court’s 1994 decision in *Kahn v. Lynch*, it has been well settled that negotiated mergers with controlling stockholders generally are subject to entire fairness review, but that defendants are entitled to shift to plaintiffs the burden of proof if the transaction is *either* negotiated by a special committee *or* conditioned on the approval of a majority of the minority stockholders. Whether *Kahn* or its progeny compelled the application of entire fairness review—as opposed to the protection of the business judgment rule—to a transaction that employed *both* procedural devices was a matter of great debate in the M&A bar.

The *MFW* litigation arose out of a June 2011 proposal by MacAndrews & Forbes Holdings Inc. to acquire M&F Worldwide (of which MacAndrews owned 43% of the outstanding stock). MacAndrews initially proposed to acquire MFW for \$24.00 per share and stated, at the outset, that its proposal was subject to (i) a non-waivable majority-of-the-minority condition and (ii) approval by a special committee. The MFW board formed and empowered a special committee of independent directors to negotiate with MacAndrews and/or reject the proposal. The special committee negotiated and recommended a transaction at \$25.00 per share, subject to approval by a majority of the minority. Sixty-five percent of the shares not owned by MacAndrews voted to approve the merger. MFW stockholders sued, alleging that the merger was not entirely fair, and sought post-closing damages for breach of fiduciary duty. The defendants moved for summary judgment, arguing that the business judgment rule should apply.

Chancellor Strine first evaluated the adequacy of the protective devices employed, finding that the factual record confirmed that (i) the special committee was composed of independent directors adequately empowered to evaluate, negotiate and reject the transaction; and (ii) a fully informed, uncoerced majority of MFW’s minority stockholders voted to approve the transaction. Notably, Chancellor Strine did not review the “effectiveness” of the special committee, stating that “[f]or a court to determine whether a special committee was effective in obtaining a good economic outcome involves the sort of second-guessing that the business judgment rule precludes.”

Having satisfied itself that the two procedural protections employed qualified “to be given cleansing credit under the business judgment rule,” the Court confronted the core question of whether the business judgment rule (or entire fairness) standard of review should apply. Chancellor Strine carefully considered

whether minority stockholders would be better protected by the application of entire fairness in all instances or by encouraging controllers to use both procedural protections, reasoning:

When these two protections are established up-front, a potent tool to extract good value for the minority is established. From inception, the controlling stockholder knows that it cannot bypass the special committee's ability to say no. And, the controlling stockholder knows it cannot dangle a majority-of-the-minority vote before the special committee late in the process as a deal-closer rather than having to make a price move. From inception, the controller has had to accept that any deal agreed to by the special committee will also have to be supported by a majority of the minority stockholders. That understanding also affects the incentives of the special committee in an important way. The special committee will understand that those for whom it is bargaining will get a chance to express whether they think the special committee did a good or poor job.

The Court concluded that “[b]y giving controlling stockholders the opportunity to have a going private transaction reviewed under the business judgment rule, a strong incentive is created to give minority stockholders much broader access to the transactional structure that is most likely to effectively protect their interests.”

It remains to be seen whether the plaintiffs in *MFW* will appeal and thus whether the Delaware Supreme Court will definitively resolve these issues. Nonetheless, the *MFW* decision has a number of practical implications, including:

- The *MFW* decision encourages controlling stockholders to condition their going-private proposals on both procedural protections described above. However, such controlling stockholders will need to consider whether the applicability of business judgment rule protection is worth taking the commercial risk of a majority-of-the-minority vote. In this regard, however, we would note that some buyers may be more willing than in the past to accept this risk given a number of developments, including:
 - the increasing willingness of the plaintiffs' bar and certain hedge funds to pursue post-closing damages claims;
 - the growing perception among M&A practitioners that the Delaware courts are increasingly skeptical of director decision-making (and banker relationships) in a conflict situation; and
 - the resulting possibility in a going-private transaction that remains subject to entire fairness review that a controlling acquirer may be forced to close a transaction without certainty as to the ultimate purchase price for the target.
- Moreover, the *MFW* decision directs that the business judgment rule will apply only if both procedural protections are established at the time of the controller's initial proposal. In other words, a controller must commit at the outset (and before knowing the reaction of the subsidiary board) not to go hostile. In addition, accepting a majority-of-the-minority vote requirement may in certain situations hand activist hedge funds the opportunity for hold-up value in connection with the transaction, which in itself is a significant disincentive to taking this alternative. Therefore, notwithstanding the above considerations, this may not prove to be an attractive trade-off in many situations, and controllers may prefer to retain optionality and to instead rely on a burden shift under entire fairness review.
- The *MFW* decision will limit the leverage of stockholder plaintiffs who file strike suits challenging negotiated mergers with controlling stockholders. Under the previous status quo, a buyer could employ a process to shift the burden in—but not avoid entirely—entire fairness review, thereby

rendering strike suits effectively immune from dismissal on the papers. The *MFW* decision provides a roadmap for the application of the business judgment rule at the motion to dismiss stage, clearing out cases that would otherwise have greater settlement value.

- In the *MFW* decision, Chancellor Strine endorsed the reasoning contained in his *Cox Communications* (Del. Ch. 2005) opinion and reiterated in Vice Chancellor Laster's *CNX Gas* (Del. Ch. 2010) opinion, which proposed that controlling stockholder freeze-out transactions should be subject to a unified standard of review, regardless of whether structured as a negotiated single-step merger or a two-step transaction. This decision aligns the standard applicable to single-step mergers with that provided for two-step transactions in *CNX*, creating a unified standard for controlling stockholder freeze-outs regardless of form.

[See a copy of *In re MFW Shareholders Litigation*, C.A. No. 6566-CS \(May 29, 2013\) >](#)

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