

# Client Alert

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## Delaware Supreme Court Affirms Business Judgment Rule Application in Controlling Stockholder “Freeze-Outs”

On March 14, 2014, the Delaware Supreme Court issued its opinion in *Kahn v. M&F Worldwide Corp.*,<sup>1</sup> affirming the Court of Chancery’s holding in *In re MFW S’holders Litigation*<sup>2</sup> that a “freeze-out” merger between a controlling stockholder and its controlled subsidiary will be reviewed under the business judgment rule if certain procedural steps are followed at the outset of the merger. Specifically, a freeze-out merger will be subject to the business judgment rule if, among other things, the controlling stockholder conditions the transaction *ab initio* on the approval of (i) an independent special committee, which is empowered to select its own advisors, has the power to “say no,” and fulfills its duty of care, and (ii) a fully informed, uncoerced vote of a majority of the outstanding minority shares. In contrast, freeze-out mergers with only one or neither of these procedural protections will continue to be subject to the exacting “entire fairness” standard of review.<sup>3</sup> This decision reflects a significant shift over the past decade in the treatment of controlling stockholder transactions, but the court’s opinion still leaves room for a judicial inquiry that may often preclude a challenge from being dismissed at the pleading stage.

### Delaware Supreme Court’s Opinion

The Delaware Supreme Court affirmed the lower court’s decision to afford the transaction business judgment review. Specifically, the Supreme Court held that a freeze-out merger will be subject to the business judgment rule if “the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; the Special Committee is independent; the Special Committee is empowered to freely select its own advisors and to say no definitively; the Special Committee meets its duty of care in negotiating a fair price; the vote of the minority is informed; and there is no coercion of the minority.”

The Supreme Court based its conclusion on four characteristics unique to the structure of the transaction. First, the court recognized that when a controlling stockholder disables itself from its control of the entity by conditioning the transaction on the approval of a special committee and the minority stockholders, the merger mimics a third-party, arm’s-length negotiation. Second, the requirement that the merger be conditioned on the approval of a special committee and a majority of the outstanding minority shares (a so-called “MOM” condition) ensures that the controlling stockholder cannot bypass the special committee’s decision or, later in the negotiation process, offer a MOM condition as a last-minute enticement for the special committee to approve the deal. Third, applying business judgment review provides a strong incentive for controlling stockholders to utilize both procedural protections, which provides better protection to the minority. Finally, the entire fairness standard and the dual protection structure of the *M&F Worldwide* transaction “converge and are fulfilled at the same critical point: price.” Utilizing dual protection, the court said, facilitates independent negotiation for the best price, followed by the vote of the minority to voice its determination on whether the price is indeed fair.

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<sup>1</sup> *Kahn v. M&F Worldwide Corp.*, No. 334, 2013 (Del. Mar. 14, 2014).

<sup>2</sup> *In re MFW S’holders Litig.*, C.A. No. 6566-CS (Del. Ch. May 29, 2013).

<sup>3</sup> See *Kahn v. Lynch Communications Sys.*, 638 A.2d 1110 (Del. 1994).

The Supreme Court's opinion, however, does not guarantee that transactions incorporating these procedural protections will always receive business judgment rule protection. In particular, footnote 14 of the Supreme Court's ruling indicated that the plaintiffs in *MFW* would have survived a motion to dismiss because the plaintiffs alleged:

- the majority stockholder's offer "value[d] the company at just four times' MFW's profits per share and 'five times 2010 pre-tax cash flow,' and that these ratios were 'well below' those calculated for recent similar transactions;"
- the final merger price was "two dollars per share lower than the trading price only about two months earlier;"
- "particularized facts indicating that MFW's share price was depressed" at the time of the majority stockholder's offer and the merger announcement "due to short-term factors such as MFW's acquisition of other entities and Standard & Poor's downgrading of the United States' creditworthiness;" and
- that "commentators viewed both [the majority stockholder's] initial \$24 per share offer and the final \$25 per share" merger price as being surprisingly low.

The Supreme Court ruled that "[t]hese allegations about the sufficiency of the price call into question the adequacy of the Special Committee's negotiations, thereby necessitating discovery on all of the new prerequisites to the application of the business judgment rule."

### **Implications**

The Delaware Supreme Court's ruling charts a course to obtain business judgment review of freeze-out mergers, but it will require careful planning by the parties. Specifically, a transaction will receive business judgment review only if:

- the controller conditions the procession of the transaction on the approval of both a special committee and a majority of the minority stockholders;
- the special committee is independent;
- the special committee is empowered to freely select its own advisors and to say "no" definitively;
- the special committee meets its duty of care in negotiating a fair price;
- the vote of the minority is informed; and
- there is no coercion of the minority.

A plaintiff can overcome a motion to dismiss by sufficiently alleging that one or more of these elements was lacking, thus entitling the plaintiff to discovery. As the Supreme Court's opinion summarized:

If a plaintiff that can plead a reasonably conceivable set of facts showing that any or all of [the] enumerated conditions did not exist, that complaint would state a claim for relief that would entitle the plaintiff to proceed and conduct discovery. If, 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.

Footnote 14 of the opinion, described above, further suggests that carefully crafted complaints will entitle plaintiffs to discovery. The allegations quoted in footnote 14 related to the fairness of the price rather than the care in which the special committee handled the process. Thus, challenges to freeze-out mergers will still possess some "settlement value," although not as much as would be the case under a per se rule of entire fairness.

Importantly, both procedural protections must be proposed by the controller at the outset. Thus, controlling stockholders will need to deliberate carefully and at an early stage to determine whether to pursue this route. If the controlling stockholder is unwilling to provide both procedural protections, the “entire fairness” standard will apply. *M&F Worldwide* still preserves the burden shifting available under existing law if either procedural protection is used.

Under *M&F Worldwide*, the role of the special committee remains particularly important. The special committee’s mandate, composition, advisors, and overall process will continue to be scrutinized by plaintiffs. The case also reiterates the importance of disclosure. The transaction will not be subject to the business judgment rule if the minority stockholder vote is uninformed or coerced.

Lastly, it bears noting that the Delaware Supreme Court did not address freeze-out mergers structured as tender offers followed by back-end mergers. The Court of Chancery has previously applied the business judgment rule to these “two-step transactions” if, among other things, approved by a special committee and conditioned on a majority of the minority shares being tendered.<sup>4</sup> Although the Delaware Supreme Court did not address those structures, its opinion in *M&F Worldwide* would seem to harmonize the judicial review of these two different transaction structures.<sup>5</sup>

## **Conclusion**

*M&F Worldwide* is a significant decision for controlled companies and culminates from a long movement to reexamine the judicial treatment of freeze-out mergers. Many practitioners, academics, and lower-court judges have urged the Delaware Supreme Court to adopt a business judgment rule test for freeze-out mergers.<sup>6</sup> Allowing business judgment rule protection would provide controllers with strong incentives to offer better protections to minority stockholders. It also would eliminate the settlement value associated with a per se rule of “entire fairness.”

In *M&F Worldwide*, the Delaware Supreme Court took a significant step in that direction, but its ruling still contemplates a judicial review that appears more searching than the “rationality” standard under the traditional business judgment rule. One senses that the Delaware Supreme Court was reluctant to establish a rule in which a high number of freeze-out cases would be dismissed at the pleadings stage. In fact, some might argue that *M&F Worldwide* is more akin to a reasonableness standard. The Delaware Supreme Court’s opinion suggests that many lawsuits may proceed at least to the summary judgment stage.

Whether this decision results in more freeze-out mergers being conditioned on the approval of both a special committee and a majority of the outstanding minority shares remains to be seen. In particular, including a MOM condition raises execution risk for freeze-out mergers. Controllers may not be willing to include a MOM condition if the benefits of doing so are uncertain. Nevertheless, the Delaware Supreme Court’s decision does chart a course to reduce the impact of stockholder lawsuits on freeze-out mergers.

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<sup>4</sup> See *In re Pure Resources, Inc. S’holder Litig.*, 808 A.2d 421 (Del. Ch. 2002).

<sup>5</sup> See *In re CNX Gas Corp. Shareholders Litigation*, 4 A.3d 397 (Del. Ch. 2010) (formulating a “unified” standard to freeze-out transactions).

<sup>6</sup> See, e.g., Peter V. Letsou & Steven M. Haas, *The Dilemma That Should Never Have Been: Minority Freeze Outs in Delaware*, 61 BUS. LAW. 25 (2005).