Client Alert

March 2020

Does Special Committee Approval Protect a Transaction Involving a Conflicted Board Majority?

In a recent case, the Delaware Court of Chancery held that a transaction in which a majority of the directors had a conflict of interest (a "conflicted board majority transaction") could still be subject to the business judgment rule if it was approved by a special committee of disinterested and independent directors. The special committee, however, must be in place from the outset of the transaction.

Court of Chancery's Opinion

In *Salladay v. Lev*, the Court of Chancery addressed a conflicted board majority transaction that was approved by a special committee.[1] Three of the six directors on the company's board were allegedly interested in a merger based on a variety of allegations, including that (i) they or their affiliates were rolling over "substantial portions" of their equity in the merger; (ii) one of them (the chairman and chief executive officer) received severance compensation and entered into an 18-month consulting agreement with the acquiror; and (iii) in connection with the merger, two of them exchanged existing notes held by the company for new convertible notes on more favorable terms.

In ruling on the defendants' motion to dismiss, Vice Chancellor Glasscock wrote that the standard of review for approving the merger, as a conflicted board majority transaction, was entire fairness unless the merger was approved by a special committee[2] or by a majority of fully informed stockholders under the *Corwin* doctrine.[3] He also held that the defendants had the burden of invoking either doctrine.

In examining the effect of the special committee in this case, Vice Chancellor Glasscock borrowed from controlling stockholder jurisprudence under *Kahn v. M&F Worldwide Corp.*, which held that a special committee must be in place from the outset of the transaction.[4] This is sometimes referred to as the "*ab initio* requirement." Vice Chancellor Glasscock reasoned that "[t]he acquirer—as well as any interested directors—must know from the transaction's inception that they cannot bypass the special committee." "Even in a non-control setting," he continued, "commencing negotiations prior to the special committee's constitution may begin to shape the transaction in a way that even a fully-empowered committee will later struggle to overcome."

Applying this rule,[5] the Court of Chancery held that the company's special committee was not in place

[1] C.A. No. 2019-0048-SG (Del. Ch. Feb. 27, 2020).
[2] *See also In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 55 (Del. Ch. 2013) ("The decision not to form a special committee had significant implications for this litigation. The Merger was not a transaction where a controller stood on both sides…. If a duly empowered and properly advised committee had approved the Merger, it could well have resulted in business judgment deference."); *see also Frederick Hsu Living Tr. v. ODN Holding Corp.*, 2017 WL 1437308 (Del. Ch. Apr. 14, 2017) ("If the board delegates its full power to address an issue to a committee, then the judicial analysis focuses on the committee. A decision made by a disinterested, independent, and informed majority of the committee receives business judgment deference."); *In re PNB Hldg. Co. S'holders Litig.*, 2006 Del. Ch. LEXIS 158, at *3-4 (Ch. Aug. 18, 2006) ("In this conflicted situation, the [] directors are bound to show that the Merger was fair… or to point to the presence of a cleansing device, such as approval by a special committee of independent directors or an informed majority-of-the-minority vote, in order to justify review under the business judgment rule.").
[3] *See Corwin v. KKR Holdings LLC*, 125 A.3d 304 (Del. 2015).
[4] *See Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).
[5] *See also Flood v. Synutra Int'l, Inc.*, 195 A.3d 754 (Del. 2018); *Olenik v. Lodzinski*, 208 A.3d 704 (Del. 2019).

"before any substantive economic negotiations began." Among other things, the plaintiff alleged that the following events occurred prior to the formation of the special committee:

- the acquiror met with two of the interested directors to "provide an overview of the Company and its financing needs, outline in broad terms how an acquisition of the Company might be approached, and gain an understanding of the [acquirer's] intentions";
- the company and the acquiror entered into a confidentiality agreement and "began a detailed due diligence process";
- the acquiror's investment banker discussed the transaction with an interested director;
- one of the interested directors told the acquiror to "base an offer on the 'independent value' rather than the trading price" of the company's stock, and "effectively told" the acquiror that the board of directors "would be receptive to an acquisition offer of $3.50 to $4.00 per share; and
- the acquiror and the company continued discussions for an additional week.

The plaintiff further alleged that the acquiror's first bid was $3.50 per share—*i.e.*, at the bottom of the range suggested by the interested director—and that the final per share price was just below the midpoint of the range.

Based on these allegations, the court held that it was reasonably conceivable that "these discussions prior to the Committee's []constitution essentially formed a price collar that 'set the field of play for the economic negotiations to come.' " This was so even though, according to the company's disclosure, the interested director informed the acquiror that he did not have authority to negotiate and was offering only his personal view.

Conclusion

Salladay confirms that a conflicted board majority transaction can be reviewed under the business judgment rule if it is conditioned on the approval of a special committee. This includes related-party transactions that are not submitted for stockholder approval. By applying the *Kahn v. M&F Worldwide* framework, however, *Salladay* makes clear the importance of process in forming and empowering a special committee at the outset of a transaction. Interested directors and potential counterparties to corporate transactions should be aware of this ruling, which indicates that some preliminary discussions with interested directors may deprive them of the business judgment rule's protection in litigation.

As the court noted, the *Corwin* doctrine similarly would have resulted in business judgment rule review. That is, outside of the controlling stockholder context, a transaction that has been approved by a fully informed and uncoerced vote of a majority of disinterested stockholders will be reviewed under the business judgment rule.[6] Here, however, the court found that the stockholders were not fully informed when approving the merger.

Finally, *Salladay* contributes to the post-*M&F Worldwide* case law governing controlling stockholder transactions. Specifically, its treatment of the *ab initio* requirement and what it deemed to constitute substantive economic negotiations may be instructive in future freeze-out mergers and other controlling stockholder transactions.

Contact:

Steven M. Haas
shaas@HuntonAK.com

[6] *See Larkin v. Shah,* 2016 WL 4485447, at *1 (Del. Ch. Aug. 25, 2016) ("In the absence of a controlling stockholder that extracted personal benefits, the effect of disinterested stockholder approval of the merger is review under the irrebuttable business judgment rule, even if the transaction might otherwise have been subject to the entire fairness standard due to conflicts faced by individual directors.").