

May 9, 2016

New York Court of Appeals Adopts Delaware Law, Affirming Business Judgment Deference for Controlling Stockholder Transactions Structured with Minority Protections

On May 5, 2016, New York’s highest court confirmed that, under New York law, business judgment deference—rather than more searching “entire fairness” review—applies to controlling stockholder transactions that are approved by a duly empowered special committee of independent directors and that receive a “majority of the minority” vote from stockholders not affiliated with the controlling party. In *In the Matter of Kenneth Cole Productions Inc. Shareholder Litigation*, a case in which plaintiffs challenged the take-private of a New York corporation by its controlling stockholder, the New York Court of Appeals affirmed the trial court’s dismissal of the case and adopted the Delaware Supreme Court’s 2014 holding in *Kahn v. M&F Worldwide Corp.* (“*MFW*”). In adopting the *MFW* framework, the Court of Appeals brought New York law into line with Delaware law, making the *MFW* mechanism available to New York corporations and offering a path for New York corporations to reduce litigation risk in connection with controlling party transactions.

The *Kenneth Cole* litigation arose in 2012 after Mr. Kenneth Cole, the controlling stockholder of the prominent fashion retailer bearing his name, offered to purchase all of the outstanding Kenneth Cole stock that he did not already own. He also made clear that he would not sell his shares to another potential acquiror. In response, the company formed a special committee of independent directors to negotiate with Mr. Cole. The special committee engaged in successful negotiations to increase Mr. Cole’s offer, and a deal was ultimately approved by the special committee and a majority of the non-controlling stockholders. Nonetheless, several stockholders sued in New York State court, challenging the transaction as unfair. In view of the protections afforded the non-controlling stockholders—an independent special committee and a majority of the minority vote—the trial court applied business judgment review and dismissed the consolidated action. After the intermediate Appellate Division affirmed and endorsed business judgment review, the plaintiff appealed to the State’s highest court, the Court of Appeals, which also affirmed.

The decision makes business judgment review available to controlling-party transactions involving New York corporations where the transaction at the outset is conditioned on its approval by both (1) a special committee comprised of independent, duly empowered directors and (2) a majority of the minority stockholders in a fully informed vote. To avoid application of business judgment review at the motion to dismiss stage, the burden is now on the plaintiff challenging the transaction to “sufficiently and specifically allege” that the protections afforded the minority were not adhered to. Absent such allegations (or sufficient allegations of fraud or bad faith), New York law requires dismissal of challenges to going-private transactions between a company and its controlling stockholder.

The Delaware Backdrop

Prior to *MFW*, the Delaware courts had treated transactions with controllers as presumptively subject to the more stringent entire fairness standard, rendering such a transaction vulnerable to attack absent a showing that the transaction was fair—as to process and price—to the minority stockholders. Since 1994, under the Delaware Supreme Court’s decision in *Kahn v. Lynch Communications Systems, Inc.*, controlling stockholders had the ability to shift the burden of persuasion on the fairness issue to the plaintiff by taking measures to protect the minority stockholders. But, regardless of the protections offered the minority, a controlling stockholder could never escape entire fairness review, meaning that, as a practical matter, a controlling stockholder could not achieve a clear

pathway to prevailing on a motion to dismiss, even if it had adequately protected the rights of the minority. Where ensuring minority protections provided relatively little transactional certainty, the incentives for controllers to implement such protections were weak.

Perhaps unsurprisingly, it was not until 2014, in its *MFW* decision, that the Delaware Supreme Court first had occasion to consider which standard of review to apply to a controller transaction that had not only been approved both by a special committee of independent directors and by a majority of the minority stockholders, but that had also been conditioned, from the outset, on such two-stage approval. Faced with this question at the trial court level, the Delaware Court of Chancery concluded that business judgment review should apply to the transaction, reasoning that the transaction's structure largely replicated that of an arm's-length transaction. The Chancery Court also noted that subjecting transactions highly protective of minority stockholders to business judgment review would incentivize controlling stockholders to build minority protections into going-private transactions, thereby benefiting those stockholders. On appeal, the Delaware Supreme Court invoked the Chancery Court's rationale and affirmed.

Kenneth Cole: A New Standard for Controller Transactions in New York

Following *MFW*, transaction planners for Delaware corporations had a solid playbook for structuring controlling stockholder transactions so as to attempt to qualify for business judgment review. However, as demonstrated by *In re Dole Food Inc. Stockholder Litigation*, formal adherence to the mechanical requirements of *MFW*—the formation of a special committee and a majority of the minority vote—does not guarantee dismissal if a plaintiff makes sufficient factual allegations that the controlling stockholder did not fully disable himself. But, for Delaware corporations, *MFW* provided clear direction on how best to immunize controller transactions from attack. In contrast, such assurances were not available to non-Delaware corporations. As evidenced by the structure of the *Kenneth Cole* deal, some transactional specialists beyond Delaware, including in New York, had been including minority stockholder protections when structuring going-private transactions. It was unclear, however, whether New York courts would apply business judgment review to those transactions.

Against this backdrop, the New York Court of Appeals in *Kenneth Cole* rejected the plaintiff's claim that the proper standard of review was entire fairness. Returning to first principles, the Court of Appeals observed that New York courts generally seek to avoid unnecessarily interfering with the internal management of corporations—hence the business judgment rule's protection of corporate decisions that are not the result of fraud or bad faith. The Court of Appeals then examined *MFW*'s rationale and found it persuasive, resulting in a wholesale adoption of *MFW*:

[I]n controller buyouts, the business judgment standard of review will be applied *if and only if*: (i) the controller conditions . . . 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.

Kenneth Cole, Slip Op. at 12. In view of this holding, transaction planners for New York corporations can now be confident that New York is squarely aligned with Delaware in deferentially reviewing controller transactions structured with the requisite minority protections.