ROPES & GRAY ALERT

Mergers & Acquisitions

March 7, 2018

Updated Guidance (and Ground Rules) for Controlling Stockholder Deals

Attorneys
Paul S. Scrivano
Jane D. Goldstein
Sarah H. Young

The Delaware Supreme Court's 2014 decision in *Kahn v. M&F Worldwide Corp*. ("*MFW*")[1] provided business judgment rule protection for controlling stockholder transactions that are conditioned from the outset on certain procedural protections being utilized, including approval by (1) a fully-empowered independent special committee that meets its duty of care and (2) a fully-informed, uncoerced vote of a majority of the target minority stockholders unaffiliated with the controller. While *MFW* provided helpful guideposts for avoiding entire fairness review in controlling stockholder transactions, as with any new doctrine, questions remained as to the application of *MFW* to different types of deals and negotiations, and the consequences of small deviations from strict adherence to *MFW*. Recent guidance from the Delaware Court of Chancery has given way to updated ground rules for controlling stockholder transactions: (i) *MFW* also applies to deals where the controller is only on the sell-side; (ii) other conflicted controller transactions besides mergers, such as recapitalizations, are eligible for *MFW* protection; and (iii) small, alleged foot faults will not cause the business judgment rule protection afforded by *MFW* to be lost.

MFW Also Applies to Deals Where the Controller Is Only on the Sell-Side

In *In re Martha Stewart Living Omnimedia, Inc. Stockholder Litigation* ("*Martha Stewart*"),[2] the Chancery Court held that the business judgment rule protection afforded in a controlling stockholder buyout in *MFW* also applied to deals where the conflicted controlling stockholder was on the sell-side (as opposed to the buy-side). In *Martha Stewart*, the controller was not the buyer, which is the *MFW* paradigm; rather, the controller received the same merger consideration as the minority stockholders but was also alleged to have received certain "side deals" from the acquirer (agreements concerning employment and IP rights, and expense reimbursement) in the transaction. Notably, Vice Chancellor Slights held that in a so-called "single side" controller deal, the time by which the *MFW* procedural protections must be in place is before negotiations begin between the buyer and the controller on such side arrangements. In *Martha Stewart*, the procedural protections were instituted after the merger negotiations began between the target company and the buyer. Contrast that with the classic controlling stockholder buyout (where the controller is buying out the minority stockholders), where the procedural protections must be in place "*ab initio*" before the buyer begins negotiations with the target company. Moreover, the Court noted that the "side deals" the controller in *Martha Stewart* negotiated, which were claimed to divert consideration away from the minority stockholders, were not materially different than the pre-deal arrangements between the controlling stockholder and the company, and, therefore, did not amount to a material conflict such that entire fairness would have been triggered by those benefits alone. Without facts sufficient to plead a failure to comply with the *MFW* procedural framework or a conflict between the controller and the minority stockholders, the Chancery Court found the business judgment rule to be the appropriate standard of review.

Other Conflicted Controller Transactions Besides Mergers, Such as Recapitalizations, Are Eligible for *MFW* Protection

In *IRA Trust FBO Bobbie Ahmed v. Crane* ("*NRG*"),[3] the Chancery Court held that a reclassification transaction that was undertaken with the procedural safeguards established in *MFW* was entitled to business judgment rule protection. In *NRG*, the controller implemented a pro rata recapitalization transaction designed to extend the controller's control over

[1] *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).
[2] *In re Martha Stewart Living Omnimedia, Inc. S'holder Litig.*, 2017 WL 3568089 (Del. Ch. Aug. 18, 2017).
[3] *IRA Trust FBO Bobbie Ahmed v. Crane*, 2017 WL 6335912 (Del. Ch. Jan. 26, 2018).

the controlled company by issuing two classes of new low-vote stock, which could be used as currency in acquisitions, without significantly diluting the controller's voting control. In exchange, the controller agreed to add additional assets to a right of first offer agreement in favor of the controlled company. Chancellor Bouchard noted that the reasoning underpinning the *MFW* framework (as well as its doctrinal predecessor *Kahn v. Lynch Communication Systems, Inc.*[4] and its progeny) was to protect minority stockholders and replicate an arm's-length bargaining process in any conflicted controller transaction, not simply mergers. Accordingly, based on Chancellor Bouchard's decision in *NRG*, business judgment protection should be available to any transaction (and not just mergers) with a conflicted controller that follows the safeguards in *MFW*.

Small, Alleged Foot Faults Will Not Cause the Business Judgment Rule Protection Afforded by *MFW* to Be Lost

Vice Chancellor Laster held in *In re Synutra International, Inc. Stockholder Litigation* ("*Synutra*")[5] that minor, alleged deviations from the *MFW* roadmap will not invalidate the protection afforded by *MFW*. The *Synutra* plaintiff alleged certain foot faults by the controller and the target. Notably, the controller's original bid letter conditioned the deal on an independent special committee but not also on a majority of the minority stockholder vote. However, two weeks later, the controller sent an updated bid letter that provided for both *MFW* procedural protections. The target company's long-time counsel originally advised the target company's board in response to the controller's proposal, but then represented the controller in the buyout. And just as negotiations got underway, an individual who was referred by a personal friend of the controller was nominated and elected as a director and special committee member. Vice Chancellor Laster rejected each of these allegations, addressing each of these in turn: substantive negotiations with the special committee only began after the updated bid letter was received; while the long-time counsel acted temporarily as counsel for both sides it was an "artless misstep"; and the fact that a director is nominated by the controller does not in and of itself rebut a presumption that a director is independent.

***

These decisions signal that the proper utilization of the procedural protections in *MFW* remains a potent shield against a plaintiff seeking to challenge a conflicted controller merger, and that this shield can also be used in other transactions involving a controller stockholder under Delaware law. While the precise contours of *MFW* protection are still being developed, these decisions provide the ground rules to controllers and boards of directors of controlled companies as to how to best structure any transaction with a controlling stockholder to protect it from challenge. Similarly, in May 2016, the New York Court of Appeals adopted the standard of review outlined in *MFW* in *In the Matter of Kenneth Cole Productions, Inc., Shareholder Litigation*.[6] It remains to be seen to what extent, if at all, the New York courts will similarly extend the *MFW* burden-reducing framework to other conflicted controller transactions.

***

If you have any questions about the contents of this alert, please contact your regular Ropes & Gray lawyer or the attorneys listed below:

Jane Goldstein (617-951-7431, jane.goldstein@ropesgray.com)
Jieni Gu (+86 21 6157 5249, jieni.gu@ropesgray.com)
David Hennes (212-596-9395, david.hennes@ropesgray.com)
James Lidbury (+852 3664 6521, james.lidbury@ropesgray.com)
Carl Marcellino (212-841-0623, carl.marcellino@ropesgray.com)
Paul Scrivano (415-315-6368, paul.scrivano@ropesgray.com)
Kiran Sharma (+44 (0)20 3201 1647, kiran.sharma@ropesgray.com)
John Sorkin (212-596-9394, john.sorkin@ropesgray.com)

[4] *Kahn v. Commc'n Sys., Inc.*, 638 A.2d 1110 (Del. 1994).
[5] *In re Synutra Int'l, Inc. S'holder Litig.*, C.A. No. 2017-0032-VCL (Del. Ch. Feb. 2, 2018) (order granting motion to dismiss).
[6] *In re Kenneth Cole Prods., Inc. S'holder Litig.*, 27 N.Y.3d 268 (2016).

Peter Welsh (617-951-7865, peter.welsh@ropesgray.com)
Sarah Young (212-596-9710, sarah.young@ropesgray.com)