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Mergers & Acquisitions Alert

Delaware Supreme Court Upholds Business Judgment for Freeze-Out Mergers; New Standard Has Significant Limitations

The Delaware Supreme Court recently upheld a widely reported Court of Chancery decision from May 2013 regarding the adoption of the "business judgment" standard for mergers employing dual protections. While the decision is a welcome step, there are clear limitations for practitioners to consider as the decision suggests that defendants will find it difficult to prevail on summary judgment or a motion to dismiss.

In a decision of first impression, the Delaware Supreme Court upheld a widely reported decision of the Court of Chancery from May of last year in *Kahn v. M&F Worldwide Corp,* C.A. No. 6566 (March 14, 2014), holding that the business judgment rule will be applied in freeze-out mergers if and only if: "(i) the controller conditions the procession of 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." Practitioners will need to evaluate uncertainties inherent in the test when determining whether to incorporate both the special-committee and majority-of-the-minority protections into their deal structures.

The case involves MacAndrews & Forbes Holdings Inc.'s 2011 acquisition of the 57 percent of the common stock of M&F Worldwide Corp. that it did not already own. The court first discussed the traditional "entire fairness" test for transactions involving self-dealing by controlling

stockholders set forth in *Kahn v. Lynch Communication Systems, Inc.*,[1] noting that the entire-fairness test applied to transactions with either of the two minority protections (special-committee and majority-of-minority approval), but not both. The court held that "business judgment is the standard of review that should govern mergers between a controlling stockholder and its corporate subsidiary, where the merger is conditioned *ab initio* upon both the approval of an independent, adequately empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders." The court noted that where only one of these procedural protections is employed, the shifting of the burden of proof under the entire fairness test to the plaintiff will still be available.

The court based its adoption of the new test on the following four reasons:

- First, the simultaneous deployment of the two procedural protections "create[s] a countervailing, offsetting influence of equal—if not greater—force" than the undermining influence of the controller.
- Second, the dual protections optimally protect minority stockholders in controller buyouts because the controlling stockholder knows from the beginning that "it cannot bypass the Special Committee's ability to say no."
- Third, application of the business judgment standard is consistent with Delaware law's tradition of "defer[ring] to the informed decision of impartial directors, especially when those decisions have been approved by the disinterested stockholders on full information and without coercion." According to the court, stockholders will get the benefit of independent agents empowered to bargain for the best price and say no, and the ability to determine for themselves whether to accept the deal.
- Fourth, the purpose of the dual protection structure and entire fairness standard "both converge and are fulfilled at the same critical point: price. . . . The dual protection merger structure requires two price-related pretrial determinations: first, that a fair price was achieved by an empowered, independent committee that acted with care; and second, that a fully informed, uncoerced majority of the minority stockholders voted in favor of the price . . ."

The court held that if a plaintiff can plead a reasonably conceivable set of facts showing that any of the conditions in the six-part test do not exist, it would entitle the plaintiff to proceed with its claim and conduct discovery. If discovery reveals triable issues of fact about whether either or both procedural protections were established, the case will proceed to trial under entire-fairness review.

While adoption of the business judgment standard for mergers employing the dual protections is a welcome step, there are clear limitations for practitioners to consider. Plaintiffs just have to plead a reasonably conceivable set of facts showing that any of the conditions in the six-part test do not exist in order to survive a motion to dismiss. In footnote 14 of *M&F Worldwide*, the court noted that the complaint in that case would have survived a motion to dismiss under the new standard for a number of reasons. First, the complaint alleged that the offer valued the company

[1] 638 A.2d 1110 (Del. 1994).

at multiples of profits per share and pre-tax cash flow that were well below those in precedent transactions. Second, the price per share was two dollars per share lower than the trading price two months earlier. Third, the complaint alleged particularized facts indicating the share price was depressed at the times of the offer and merger announcement. Fourth, the complaint alleged that commentators viewed the price per share as low. It may not be difficult for plaintiffs to make these sorts of claims in most freeze-out mergers.

The decision also suggests that defendants will find it difficult to prevail on summary judgment. For example, in reviewing the independence, mandate and process of the Special Committee in *M&F Worldwide,* the court noted: "deciding whether an independent committee was effective in negotiating a price is a process so fact-intensive and inextricably intertwined with the merits of an entire fairness review (fair dealing and fair price), that a pretrial determination of burden shifting is often impossible." Discovery is likely to reveal triable issues of fact in many freeze-out mergers. If the complaint cannot be dismissed on a motion to dismiss on a pre-trial summary judgment motion, it will proceed to trial under an entire-fairness standard of review.

Practitioners will have to make a determination as to whether the benefit and likelihood of achieving the business judgment standard—as compared with an entire-fairness standard with the burden of proof shifted to the plaintiff —offsets the additional deal risk associated with an irrevocable majority-of-the-minority condition. One only needs to look at the recent Dell deal for an example of the deal risk introduced by a majority-of-the-minority condition.

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