KAYE | SCHOLER

November 24, 2014

Litigation Alert

Affirmation of Business Judgment Rule in Going Private Deals Could Insulate Companies Against Costly Litigation

The New York Appellate Division for the First Department recently upheld the dismissal of a minority shareholder action challenging the terms under which a company would be taken private. The Appellate Division's decision is significant because it provides companies with a roadmap for insulating deals from costly litigation.

On November 20, 2014, the New York Appellate Division for the First Department upheld the dismissal of an action brought by minority shareholders against Kaye Scholer clients, Kenneth Cole Productions Inc. and former CEO Paul Blum, and others (*In re Kenneth Cole Productions Inc. Shareholder Litigation*), challenging the terms under which the company would be taken private. In September 2013, the New York State Supreme Court (Judge Lawrence Marks) applied the business judgment rule, siding with Kaye Scholer and lawyers for co-defendants and dismissing the case.

Plaintiff appealed the case and in a decision dated November 20, 2014, the Appellate Division, First Department, unanimously affirmed the dismissal finding that defendants had taken all appropriate steps in structuring the deal, including appointment of a four-person independent special committee and requiring the approval of a majority of the minority shareholders.

The Appellate Division also found that the plaintiff had not adequately alleged that the board members who voted on the merger were self-interested or that the members of the Special Committee, which was established to provide an independent review of the transaction, were controlled by Mr. Cole. The Appellate Division agreed with defendants that the nomination of individuals by Mr. Cole was insufficient to support the allegation that they were controlled. The Court also held that general allegations that the proxy statement sent to shareholders was incomplete or misleading were insufficient.

Most significantly, the Appellate Division affirmed the lower court's application of the business judgment rule in these circumstances. The business judgment rule provides a presumption that directors' decisions and actions constitute good faith and valid exercises of business judgment that will not be second-guessed unless a plaintiff rebuts that presumption with specific evidence that the directors did not act in good faith or had a conflict of interest. In contrast, a review under the entire fairness standard does not involve such deference to the directors' decisions and instead requires a thorough review of the transaction, including the fairness of the final price as well as the negotiation process. Because of the fact-intensive nature of the analysis under the entire fairness standard, cases involving decisions subject to this review are rarely dismissed at the pre-discovery stage.

This decision is particularly important given that virtually every major merger or going private transaction is immediately challenged in shareholder litigation, often involving a race by plaintiff representatives to be the first to file a complaint, sometimes mere hours after the deal is announced without regard for the terms. This litigation is expensive and, once a case survives the motion-to-dismiss stage, defendants often settle even where there is no merit to the allegations in order to avoid costly and intrusive discovery. The Appellate Division's decision in this case is important because it provides companies with a roadmap for insulating deals from costly litigation.

Contact Us

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