

Client Alert

Corporate Practice Group

July 1, 2013

In re MFW Shareholders Litigation

Business Judgment Standard of Review Applies to a Going Private Transaction with a Controlling Stockholder That is Approved by a Properly Organized Special Committee and Subject to a Fully-Informed Majority-of-Minority Vote

On May 29, 2013, the Delaware Chancery Court (Strine, C.) held that when a controlling stockholder merger has, from the time of the controller's first overture, been subject to (1) negotiation and approval by a special committee of independent directors fully empowered to say no to the controlling stockholder and which has met its duty of care, and (2) approval by an uncoerced, fully informed vote of a majority-of-the-minority stockholders, the business judgment rule standard of review applies. Accordingly, under such a standard, a Delaware court would be (a) precluded from inquiring into the substantive fairness of the transaction and (b) required to dismiss the challenge to the merger, unless the merger's terms were so disparate that no rational person acting in good faith could have thought the merger was fair to the minority.

The *MFW* decision is significant as it addresses the question of whether a merger with a controlling stockholder could be subject to a standard of review other than entire fairness.

Although the *MFW* decision may be scrutinized by the Delaware Supreme Court, and it remains to be seen how frequently a controlling stockholder would be willing to condition a transaction on a majority-of-the-minority stockholder vote, the *MFW* case nonetheless provides important structuring guidance to parties considering a merger with a controlling stockholder.

Background

MacAndrews & Forbes, a holding company whose equity is solely owned by Ronald Perelman, owned approximately 43% of M&F Worldwide (MFW). On June 13, 2011, MacAndrews & Forbes sent a

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proposal to the MFW board proposing to acquire the remaining shares in MFW it did not own for \$24 in cash, which price represented a premium of approximately 41.5% to the prior business day's closing share price. The proposal stated that (1) MacAndrews & Forbes would not move forward with the transaction unless it were approved by a special committee of the board, (2) the transaction would be subject to a non-waivable condition requiring the approval of a majority of the shares not owned by MacAndrews & Forbes, (3) MacAndrews & Forbes was not interested in selling its shares in MFW nor would it expect to vote in favor of any alternative transaction involving MFW, and (4) MacAndrews & Forbes would remain as a long-term stockholder of MFW if the transaction were not approved by the special committee and a majority of the non-MacAndrews & Forbes shares.

The MFW board then formed a special committee to evaluate the proposal. The special committee was empowered to evaluate, investigate and negotiate the terms of MacAndrews & Forbes' proposal (the approval of which would be subject to the approval of MFW's board) and to hire its own legal and financial advisors. Critically, the special committee was accompanied by the clear authority to say no definitively to MacAndrews & Forbes, and MacAndrews & Forbes promised that it would not proceed with any going private proposal if it did not have the special committee's support. The special committee did not, however, have the authority to market MFW to other potential buyers, though it did have the ability to get advice from its financial advisor about the strategic options available to MFW, including the interest that other buyers might have if MacAndrews & Forbes were willing to sell.

The special committee and its advisors met eight times over the summer of 2011, considered MFW's other strategic options, and ultimately extracted a \$1 per share increase to MacAndrews & Forbes' proposed purchase price. The committee recommended this \$25 per share transaction to the MFW board, which also approved the transaction. The merger was then approved by the affirmative vote of the majority-of-the-minority of MFW stockholders, with 65% of them approving the merger.

MacAndrews & Forbes, Mr. Perelman, and MFW's directors were sued by stockholders alleging that the merger was unfair and sought a post-closing damages remedy for breach of fiduciary duty. The defendants moved for summary judgment, arguing that the approval of both the special committee and the non-controlling stockholders entitled them to the protections of the business judgment rule (which would require the court to dismiss the challenge to the merger unless the merger's terms were so disparate that no rational person acting in good faith could have thought the merger was fair to the minority).

The Court's Decision

Empowerment of Special Committee

The *MFW* court held that it was undisputed that the special committee was empowered to negotiate with MacAndrews & Forbes. The court cited the fact that the committee had the clear authority to say "no" definitively to MacAndrews & Forbes and, since MacAndrews & Forbes promised that it would not proceed

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with any going private proposal that did not have the support of the committee, the committee did not have to fear that if it bargained too hard, MacAndrews & Forbes could bypass the committee and make a tender offer directly to the minority stockholders.

In addition, although the special committee did not have the authority to market MFW to other bidders, the court found that, because MacAndrews & Forbes had plainly stated that it was not interested in selling its interest in MFW, it was unlikely that any other bidder would incur the costs of exploring a purchase of MFW. Moreover, the court noted that the special committee could (and did) study a full range of financial information to inform itself of other options that might be open to MFW.

Independence of the Special Committee

The *MFW* court also held that each member of the special committee was independent under Delaware law. Under Delaware law, there is a presumption that directors are independent, and to show that a director is not independent, a plaintiff must demonstrate that the director is beholden to the controlling party or so under the controller's influence that the director's discretion would be sterilized. Mere allegations that directors are friendly with, travel in the same social circles, or have past business relationships with the proponent of a transaction are not enough to rebut the presumption of independence. Instead, a plaintiff must meet a "materiality" standard to establish that a director was not independent.

In determining the independence of the committee members, the court emphasized the financially subjective nature of the inquiry, noting that it was necessary to look to the financial circumstances of the director in question to determine whether a specific director's independence is compromised by factors material to that director. In this light, the court found that the relationships of the committee members with Mr. Perelman were immaterial, as were approximately \$100,000 in consulting fees a committee member had received from MacAndrews & Forbes four years earlier and \$200,000 in legal fees that one committee member's law firm had received over a two year period for advising MacAndrews & Forbes.

Application of Business Judgment Rule

The *MFW* court carefully reviewed prior Delaware precedent and determined that the Delaware Supreme Court had not definitively answered the question of whether the business judgment rule would apply if a controlling stockholder conditions a merger on the approval by both (1) a special committee of independent directors fully empowered to say no, and (2) an uncoerced, fully informed vote of a majority-of-the-minority stockholders.

The plaintiffs in *MFW* relied most heavily on the Delaware Supreme Court's analysis in *Kahn v. Lynch*, which involved a merger between a parent corporation (Alcatel) and a subsidiary that it controlled (Lynch). In that transaction, Lynch created a special committee to negotiate with Alcatel. The *MFW* court, however,

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distinguished *Kahn v. Lynch*, noting that the transaction in that case was not conditioned on the approval of the non-Alcatel stockholders. Moreover, the *MFW* court noted that the special committee was not empowered to say no to Alcatel because Alcatel reserved the right to (and did in fact threaten to) approach the Lynch stockholders with a tender offer at a lower price. In addition, according to the *MFW* court, the Delaware Supreme Court in *Lynch* was only asked to determine what standard of review applied when a controlling stockholder merger was approved by a special committee, not by a special committee and a non-waivable majority-of-the-minority vote. Accordingly, the *MFW* court determined that the binding holding in *Lynch* was that entire fairness review was the proper standard of review when an interested cash out merger is subject to approval of minority stockholders or a special committee.

After determining that the *MFW* case presented a novel question of law, the court held that applying the business judgment rule to the transaction at hand was appropriate. The *MFW* court noted the following in reaching this conclusion:

- Delaware courts have applied a business judgment review to controlling stockholder freeze-outs structured as a tender offer;
- While an entire fairness review was appropriate when both procedural protections were used in isolation — employing a special committee alone deprives stockholders of the chance to protect themselves through a stockholder vote, while employing only a majority-of-the-minority vote deprives stockholders of an independent agent bargaining on their behalf — they effectively protect minority stockholders when used in tandem;
- The use of both procedural protections replicates the arm’s-length merger steps of the DGCL by requiring two independent approvals, which approvals serve independent integrity-enforcing functions;
- Market developments in recent years have led to an increase in the power of modern stockholders, as the increase in available public commentary, the increase in institutional investor holdings in the last twenty years, and the communications facilitated by the internet, have made it easier for a blocking position of minority stockholders to be assembled;
- Any potential threat of coercion by the controlling stockholder is minimized under the *MFW* ruling, since (1) the transaction would only get business judgment rule review if the controlling shareholder foregoes the chance to go directly to stockholders from the inception of its proposal, and (2) there are potent remedies under Delaware law that prevent controlling stockholders from discriminating against minority stockholders; and
- The benefits of an entire fairness review in this context were “slim to non-existent”, while the costs of an entire fairness review (primarily litigation costs) are ultimately borne by investors in the form of higher D&O insurance fees and other costs of capital.

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Implications of the Court's Decision

The *MFW* decision has the following implications:

- Applying a business judgment review to freeze-out transactions in these circumstances will reduce the costs associated with such transactions, as under a business judgment rule standard of review, a Delaware court would be (a) precluded from inquiring into the substantive fairness of a controlling stockholder merger and (b) required to dismiss the challenge to the merger unless the merger's terms were so disparate that no rational person acting in good faith could have thought the merger was fair to the minority.
- It remains to be seen how often parties will be willing to implement both procedural protections. Controlling stockholders may not be willing to condition a transaction on a majority-of-the-minority vote, or the parties may determine only to form an independent special committee and take comfort from the fact that this approach would shift the burden to the plaintiffs in an entire fairness review.
- While the *MFW* opinion provides a framework by which a controlling stockholder transaction will be subject to a business judgment review, it provides a precise procedural framework (i.e., conditioning the transaction from inception on a majority-of-the-minority vote, fully empowering the special committee to say no to the controlling stockholder, etc.) to achieve such review. If the parties to a controlling stockholder freeze-out do not precisely follow this framework, the transaction may not be subject to a business judgment review.
- The *MFW* decision (or its progeny) may undergo scrutiny from the Delaware Supreme Court.

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