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New York Follows Delaware, Applies Business Judgment Rule to Going-Private Mergers

On May 5, 2016, the New York Court of Appeals ruled that courts should apply the business judgment rule in shareholder lawsuits challenging going-private mergers, as long as shareholders were adequately protected—a decision that expressly follows the approach of the Delaware Supreme Court in its seminal case, *Kahn et al. v. M&F Worldwide*, 88 A.3d 635 (Del. 2014) ("*MFW*"). *In the Matter of Kenneth Cole Productions Inc. S'holder Litig.*, No. 54, 2016 WL 2350133 (N.Y. May 5, 2016) ("*KCP*"). KCP marks the first time that New York's highest court determined that the business judgment rule should apply in such situations.

Background of the Case

Kenneth Cole Productions involved a merger between Kenneth Cole Productions, Inc., a New York corporation with two classes of common stock, and its controlling stockholder, Kenneth Cole. At the time in question, Cole held roughly 89% of shareholder voting power. The board of directors of the company consisted of two directors who were elected by Class A shareholders, and another two directors who were elected by both Class A and Class B shareholders. Since Cole held all of Class B stock, the structure meant that he could fill two of the positions as he saw fit.

Cole announced his intent to offer to buy the rest of the Class A shares, thereby taking the company private, at a board meeting in February 2012. Immediately after the announcement, the board established a special committee, which consisted of the other four directors, for the purpose of evaluating and negotiating the transaction. At the end of the month, Cole made an offer that was conditioned on (1) the approval of the special committee, followed by (2) the approval of a majority of the minority shareholders. Separate class actions were brought in the days after Cole's proposal, alleging claims against Cole and the other directors. Nevertheless, the committee proceeded with the transaction: it hired independent counsel and a financial advisor, and continued negotiations. The Committee sought higher offers from Cole several times, and after months of negotiations, it approved an offer and recommended the transaction to the minority shareholders. 99.8% of the minority shareholders voted in favor of the merger.

Plaintiff sought (1) a judgment declaring that Cole and the directors breached their fiduciary duties, (2) an order enjoining the transaction, and (3) an award of damages. The Supreme Court dismissed the complaint, and the First Department of the Appellate Division affirmed, holding that "[the Supreme Court] was not required to apply the 'entire fairness' standard to the transaction," citing several factors that distinguished the KCP transaction from transactions that were subject to the entire fairness standard: here, the transaction required the approval of minority shareholders, Cole did not vote on the transaction, and the plaintiff did not allege that the remaining board

members were self-interested. 233 AD3d 500, 500 (1st Dept. 2014), *citing Alpert v. 28 Williams St. Corp.*, 63 N.Y.2d 557 (1984).

Legal Context

In *MFW*, a case of first impression, the Delaware Supreme Court held that the standard that should be applied to certain going-private mergers was not entire fairness, but the business judgment rule. Defendants would benefit from the more deferential business judgment rule as long as six procedural safeguards had been met in the transaction: (1) the controlling shareholder conditioned the transaction on the approval by a majority of the minority shareholders and a Special Committee; (2) the Special Committee was independent; (3) the Special Committee was able to select its own independent advisors and could say no definitively; (4) the Special Committee met its duty of care in negotiating a fair price; (5) the minority shareholders had an informed vote; and (6) the minority shareholders were not coerced. Importantly, however, in a footnote (footnote 14), the Delaware Supreme Court indicated that Delaware courts would be reluctant to grant motions to dismiss, even if the procedural protections were present, and implied that summary judgment would be more readily available. Additionally, the Court did not completely rule out the application of the entire fairness standard: the Court noted that if triable issues of fact remain, after discovery, regarding whether the safeguards were established (or were effective), “the case will proceed to a trial in which the court will conduct an entire fairness review.”

The facts in *KWP* also presented an issue of first impression to the Court of Appeals of New York. In New York, until *KWP*, the case controlling freeze-out mergers was *Alpert v. 28 Williams St. Corp.* (63 N.Y.2d 557) (1984). *Alpert* held that when there is an inherent conflict of interest in a two-step merger, “the burden shifts to the interested directors or shareholders to prove good faith and the entire fairness of the merger.” However, the rule derived from *Alpert* was explicitly limited to two-step mergers, and there was also no independent Special Committee in *Alpert*, nor a minority shareholder vote.

The Court of Appeals’ Analysis

The Court of Appeals explicitly tackled the question of whether to apply the entire fairness standard as enunciated in Alpert, or whether to apply the business judgment rule as the Delaware Supreme Court had done in *MFW*. Beginning with the premise that “courts should strive to avoid interfering with the internal management of business corporations,” the Court discussed the holding in *MFW* in detail. The Court of Appeals noted that it was an issue of first impression for the Delaware Supreme Court, since the controlling stockholder in the transaction at issue had conditioned the going-private merger on both the approval of the Special Committee and the minority shareholders. Because the presence of both of these protections “replicate[d] an arm’s length transaction and support[ed] the integrity of the process,” the standard adopted by Delaware Supreme Court was likely to protect minority shareholders. Additionally, the application of the business judgment rule to going-private transactions would incentivize controlling stockholders to structure them with such protections.

The Court of Appeals fully agreed with the reasoning of the Delaware Supreme Court, writing that “the *MFW* standard properly considers the rights of minority shareholders . . . and balances them against the interests of

directors and controlling shareholders in avoiding frivolous litigation and protecting independently-made business decisions from unwarranted judicial interference." Now, in New York, as in Delaware, plaintiffs must allege "a reasonably conceivable set of facts"[1] demonstrating that any of the six factors enumerated in *MFW* were not present in the transaction at issue (quoting *MFW*). If a plaintiff meets the pleading requirements, to survive summary judgment, it must demonstrate that there is a question of fact as to "the establishment or efficacy" of any of the six factors. And, "if the evidence demonstrates that any of the protections were not in place, then the business judgment rule is inapplicable and the entire fairness standard applies." The Court applied the *MFW* standard to the transaction, and reasoned that Plaintiff did not "sufficiently and specifically allege" that any of the six conditions were absent. It noted that from the beginning of Cole's proposal, the merger was conditioned by the approval of the Special Committee and by the minority shareholders. Additionally, despite the fact that Cole was essentially able to appoint two of the directors who were on the Special Committee, the Court determined that "[f]riendships, traveling in the same circles, some financial ties, and past business relationships are not enough to rebut the presumption of independence." None of Plaintiff's alleged facts were sufficient to indicate the presence of fraud or self-interested conduct on the part of the directors—the fact that they had been appointed by Cole was not *per se* evidence of partiality.

Disposing of the rest of the factors, the Court of Appeals determined that the business judgment rule applied to the transaction. Because there was no evidence of fraud or bad faith, the Court "defer[red] to the determinations of the special committee and the KCP board of directors in recommending and approving the merger," and affirmed the judgment of the Appellate Division.

[1] The Court of Appeals qualified this seemingly new pleading standard, writing that it was "for the purposes of this rule."

Implications of the Decision

Much has already been written about the ramifications of the *MFW* case. With *KCP*, these ramifications are now also applicable in New York. Controlling shareholders of New York companies now have relatively clear instructions for going-private transactions, in order to avoid future review under the entire fairness standard. And defendants have a mechanism to help combat the costly and often frivolous shareholder litigation that arises immediately after the announcement of a going-private transaction. It is especially important that in New York this mechanism can be deployed early on in the litigation, arming defendants with the ability to dismiss the litigation at the pre-discovery stage. By contrast, *MFW* indicated (and subsequent practice has demonstrated) that Delaware courts would be reluctant to grant motions to dismiss, even if the transaction met the *MFW* test. Finally, any controlling stockholder who adheres to the protections enunciated by *KCP* also accepts a certain amount of execution risk by doing so—particularly by making the transaction contingent on approval by the minority shareholders. As a result, few controlling shareholders of Delaware companies have used the *MFW* approach. In each case, the particular circumstances of the deal will need to be taken into account before attempting to preserve any future application of the business judgment rule.

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