Delaware ups protection for controlling stockholder buyouts

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By Eric S. Waxman

Last month, the Delaware Supreme Court bolstered the protection afforded to majority or controlling stockholders seeking to buyout the minority, provided the transaction is structured in accordance with the requirements set forth in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) (MFW). In a summary order in *Swomley v. Schlecht*, No. 180, 2015 (Del. Nov. 19, 2015), the court affirmed Vice Chancellor Travis Laster's transcript ruling that it is appropriate to determine at the pleading stage whether a controlling stockholder transaction complies with MFW's requirements and is therefore covered by the business judgment rule.

The affirmance answers the riddle raised by MWF's enigmatic footnote 14, which some commentators thought might suggest the issue could only be decided on a motion for summary judgment or after a full trial. In so ruling, the court recognized that the benefits accruing to a controlling stockholder who chooses to comply with MFW would be substantially eroded if, despite providing minority stockholders with the protections afforded by the combination of an independent special committee and a "majority of the minority" vote, any litigation challenging the transaction could not be disposed of at the pleading stage.

The "MFW Standard"

Although it had been nibbling at the issues since *In re Cox Communications Inc. Shareholders Litigation*, 879 A. 2d 604 (Del. Ch. 2005), the Delaware Court of Chancery squarely addressed what standard of review should apply to a going-private merger conditioned upfront by the controlling stockholder on approval by both a properly empowered, independent committee and an informed, uncoerced majority-of-the-minority vote in *In re MFW Shareholders Litigation*, 67 A.3d 496 (Del. Ch. 2013), *aff'd, Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

In that opinion, then-Chancellor Leo Strine concluded that the business judgment rule would be applicable to controlling stockholder transactions if the following six conditions were satisfied: "(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; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority."

Strine said such a rule would "provide a strong incentive for controlling stockholders to accord minority investors the transactional structure that respected scholars believe will provide them the best protection." He reasoned that those two protections in tandem are more valuable to stockholders than the more abstract benefits derived from a higher standard of review because there is a "strong incentive [ ] created to give minority stockholders much broader access to the transactional structure that is most likely to effectively protect their interests" and which "replicates the arm's-length merger steps of the [Delaware General Corporation Law] by 'requir[ing] two independent approvals.'"

Moreover, for transactional planners, the rule provides "a basis to structure transactions from the beginning in a manner that, if properly implemented, qualifies for the business judgment rule, the benefit-to-cost ratio of litigation challenging controlling stockholders for investors in Delaware corporations will improve, as suits will not have settlement value simply because there is no feasible way for defendants to get them dismissed on the pleadings."

On appeal, the Delaware Supreme Court affirmed Strine's decision and approved the new standard; however, it modified the fourth requirement to state that the special committee must meet its duty of care "*in negotiating a fair price*," signaling that perhaps a more fact-intensive inquiry is required. That modification and the much-discussed footnote 14, which indicated that the MFW complaint would have withstood a motion to dismiss, led some commentators to suggest that the court intended for the standard to be applied only after discovery. A subsequent Court of Chancery decision, *ACP Master Ltd. v. Sprint Corp.*, No. 8508-VCL (Del. Ch. June 18, 2014), lent further support to this theory when Vice Chancellor Laster indicated that Sprint had put forth the "strongest possible" case that it met MFW's requirements, yet still denied Sprint's motion to dismiss.

Swomley Clarifies MFW

In upholding *Swomley*, the Delaware Supreme Court clarified whether a lower court could evaluate the MFW test at the pleading stage. *Swomley* involved a challenge to a merger by which SynQor Inc. was acquired by a management group that owned approximately 46 percent of the company. Following the MFW roadmap, the merger was conditioned on (i) the approval of an independent and fully empowered special committee and (ii) a majority vote of the unaffiliated stockholders who owned 54 percent of the company prior to the merger. The special committee recommended in favor of the transaction, which was then approved by 61 percent of the unaffiliated stockholders.

In dismissing plaintiffs' complaint after the transaction closed, Vice Chancellor Laster held that the MFW standard could be applied at the pleadings stage. The court cited *In re Cox Communications*, 879 A.2d 604 (Del. Ch. 2005), stating that "*the whole point* of encouraging this structure was to create a situation where defendants ... could obtain a *pleading-stage dismissal* against breach of fiduciary duty claims." (Emphasis added.) The court went on to point out that, the MFW standard "was born with the goal of establishing a technique, a practice, a structure, where, at the pleading stage, defendants could show that they were not subject to a breach of fiduciary duty challenge." (Emphasis added.)

In applying MFW's six-factor test at the pleading stage, Laster said the court's role is "to consider whether the plaintiffs have pled facts sufficient to call into question the existence of [the six elements of the *MFW* test], at least when those elements have been described in a public way suitable for judicial notice, such as board resolutions and a proxy statement." While noting there was some ambiguity as to whether the offer was conditioned at the outset by a non-waivable "majority-of-the-minority" vote, the Court of Chancery was satisfied that, to the extent there was any ambiguity, it was resolved at the initial board meeting where the transaction was first raised before any negotiations took place.

The court found no issue on the remaining elements, noting that it was not enough for plaintiffs to claim unfair price as a means of showing that the committee did not satisfy its duty of care. Rather, the plaintiffs had to allege facts showing gross negligence, a showing "that really requires recklessness ... a very tough standard to satisfy." Noting the increase in price negotiated by the committee as well as other improvements to the proposed transaction, the court found that plaintiffs' allegations attacking the methodology underlying the fairness opinion were insufficient to state a claim that the committee failed to meet its duty of care in negotiating a fair price.

The court also rejected plaintiffs' allegations that the vote was coercive because the alternative to the merger was the maintenance of an unattractive status quo as opposed to pursuing other potential options, noting that "the question for coercion is whether you can return to the status quo" not whether there might be some more favorable alternative. Finally, the court answered in the negative its own question as to whether SynQor's status as a private company meant that the MFW factors did not apply, pointing out that "[h]istorically, we haven't made any distinctions between public companies and private companies."

Guidance for Practitioners

The Delaware Supreme Court's affirmance in *Swomley* should encourage transaction planners to follow the MFW requirements in structuring buyouts by controlling stockholders, recognizing that litigation challenging such transactions can be resolved on a motion to dismiss if the MFW pathway is followed. In doing so, however, there should be no ambiguity with respect to whether the initial proposal is conditioned on a majority of the minority vote to avoid raising any unnecessary confusion on that point at the pleading stage.

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