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June 3, 2013

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Corporate Governance Group Client Alert: Deferential Business Judgment Rule Can Apply to Going Private Transactions with Controlling Stockholders

Court of Chancery determines that the use of both a special committee and majority-of-the-minority vote will result in application of the business judgment rule

In *In Re MFW Shareholders Litigation*[1], Chancellor Strine held that the standard of judicial review applicable to going private mergers with controlling stockholders should be the deferential business judgment rule if all of the following conditions are 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."

Accordingly, in such event, Courts would be "precluded from inquiring into the substantive fairness of [a going private] merger" because the entire fairness standard of review would no longer apply, and instead, Courts would be required under the business judgment rule 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".

BACKGROUND

MacAndrews & Forbes (M&F), a holding company entirely owned by Ron Perelman, was a 43% owner of M&F Worldwide (MFW), an NYSE-listed company with four distinct business segments.

[1] C.A. No. 6566-CS (May 29, 2013).

In May 2011, "Perelman began to explore the possibility of taking MFW private." On June 13, 2011, M&F sent a proposal to the MFW board to acquire the remaining MFW shares for $24 in cash, which represented "a 47% premium to the closing price before [M&F]'s offer". Of note, the M&F proposal stated that:

- it was M&F's expectation that the MFW Board would appoint a "special committee of independent directors to consider" its proposal and to "make a recommendation to the Board of Directors";
- M&F "will not move forward with the transaction unless it is approved by such a special committee" and "the transaction will be subject to a non-waivable condition requiring the approval of a majority of the shares of the Company not owned by M&F or its affiliates...";
- M&F was only interested in acquiring MFW shares not already owned by M&F and was not interested in selling any of its MFW shares or voting in favor of "any alternative sale, merger or similar transaction" involving MFW; and
- in the event that "the special committee does not recommend or the public stockholders of the Company do not approve the proposed transaction, such determination would not adversely affect" the "future relationship with the Company" and that M&F "would intend to remain as a long-term stockholder."

The MFW board met the following day to consider M&F's proposal and resolved:

- to form and empower a special committee of independent directors to "evaluate the terms of the Proposal;...negotiate with [M&F] and its representatives any element of the Proposal [and]...the terms of any definitive agreement with respect to the Proposal...;... report to the Board its recommendations..., including a determination and recommendation as to whether the Proposal is fair and in the best interests of the stockholders...; and...determine to elect not to pursue the Proposal...";
- that the MFW Board "shall not approve the Proposal without a prior favorable recommendation of the Special Committee"; and
- to empower the "Special Committee...to retain and employ legal counsel, a financial advisor, and such other agents as the Special Committee shall deem necessary or desirable...".

Accordingly, the special committee hired its own legal and financial advisors and began to evaluate and negotiate the proposal with M&F and its advisors. Of note, even though M&F made clear in its proposal that it was not willing to pursue any alternative transaction other than its proposed acquisition, "the special committee did consider, with the help of its financial advisor, whether there were other buyers who might be interested in purchasing MFW, and whether there were other strategic options, such as asset divestitures, that might generate more value for minority stockholders than a sale of their stock to [M&F]".

In terms of the actual negotiations, the special committee responded to M&F's $24.00 per share proposal with a $30.00 counter, which was flatly rejected by M&F. M&F eventually came back with a "best and final" offer of $25.00 per share. After the special committee's eighth and final meeting, during which the special committee's financial advisor opined that such $25.00 per share price was fair, the offer was unanimously approved by the special committee and recommended to the entire MFW Board. Following, the remaining MFW directors unanimously voted in favor of the M&F offer.

On November 18, 2011, MFW delivered a proxy statement that contained "the history of the merger", made "clear, among other things, that the special committee had countered at $30 per share, but only was able to get a final offer of $25 per share", indicated that the special committee's financial advisors received and relied on new, lower management projections, and disclosed "five separate ranges for the value of MFW's stock" that the special committee's financial advisor had produced. On December 21, 2011, following 65% of stockholders not affiliated with M&F voting to accept M&F's offer, the merger closed.

The plaintiffs, who are public stockholders of MFW, filed suit seeking post-closing damages for breach of fiduciary duty.

THE COURT'S ANALYSIS

Chancellor Strine's analysis is essentially divided into two parts. The first component addresses whether the facts before the Court present a novel issue of law or whether the Supreme Court has previously answered the question currently being posed by MFW. Naturally, any prior Supreme Court decisions would bind the Court of Chancery "by that answer". The second component of the *MFW* decision discusses whether the procedural protections employed by MFW – namely use of *both* a special committee and approval by a majority of the non-controlling stockholders – qualify as sufficient "cleansing devices" under Delaware law to warrant application of the business judgment rule.

Novel Question of Law

Prior to the *MFW* decision, Delaware case law regarding the judicial standard of review for going private transactions was arguably "inconsistent" and "uncertain". For example, the Supreme Court previously held that "the approval by either a special committee *or* the majority of the non-controlling stockholders of a merger with a buying controlling stockholder would shift the burden of proof under the entire fairness standard from the defendant to the plaintiff". [*emphasis added*] This language "could be [, and was,] read as suggesting that a controlling stockholder who consented to both procedural protections..." would still be subject to the entire fairness

standard of review (even though no case law was directly on point to support this reading).

But as Chancellor Strine noted, and the plaintiffs conceded, "the Supreme Court has never been asked to consider whether the business judgment rule applies if a controlling stockholder conditions the merger upfront on approval by an adequately empowered independent committee that acts with due care, ***and*** on the informed, uncoerced approval of a majority of the minority stockholders". [*emphasis added*]. Rather, in all prior Supreme Court decisions, the approval of a special committee was the only procedural protection employed (and, in such cases, the special committee was either not independent or its approval was deemed to be coerced by the controlling stockholder).

Even though no "prior [Supreme Court] decisions hinged" on the exact question before Chancellor Strine, plaintiffs nevertheless contended that the standard of review in all going private mergers should be the entire fairness standard of review, regardless of whether one or both procedural protections are employed by a target board. Plaintiffs rely on general principles set forth in prior Supreme Court decisions such as a "controlling or dominating shareholder standing on both sides of a transaction, as in a parent-subsidiary context, bears the burden of proving its entire fairness."

To Chancellor Strine, however, such general principles are "dictum" at best, and accordingly, such "broad judicial statements...when taken out of context, do not constitute binding holdings". The Court held, therefore, that the question before it was a novel issue of law never directly answered by the Supreme Court.

Application of the Business Judgment Rule

Before answering the "the ultimate question the defendants pose" as to whether the business judgment rule should apply, the Court had to determine that both of the procedural protections qualified as "a cleansing device...having sufficient integrity to invoke the business judgment standard."

- *Special committee*: The Court noted that to "the extent that the fundamental rule is that a special committee should be given standard-influencing effect if it replicates arm's-length bargaining, that test is met if the committee is independent, can hire its own advisors, has a sufficient mandate to negotiate and the power to say no, and meets its duty of care." With respect to each component of the foregoing test, the Court described in detail how the MFW special committee satisfied it and was therefore a "cleansing device".
- *Majority-of-the-minority vote*: The Court noted that "the uncoerced, fully informed vote of disinterested stockholders is entitled to substantial weight" and that in a going private situation, such a procedural protection by itself is "sufficient to shift the burden of persuasion to the plaintiff under the entire fairness

standard". Turning to the facts at hand, the Court noted that "the plaintiffs themselves...fail to allege any failure of disclosure or any act of coercion" in the context of the majority-of-the-minority vote. "Here, therefore, it is clear that as a matter of law, the majority of the minority vote condition qualifies as a cleansing device under traditional Delaware corporate law principles."

Based on the foregoing, Chancellor Strine concluded that "when a controlling stockholder merger has, from the time of the controller's first overture, been subject to (i) negotiation and approval by a special committee of independent directors fully empowered to say no, and (ii) approval by an uncoerced, fully informed vote of a majority of the minority investors, the business judgment rule standard of review applies."

To conceptualize this novel application of the business judgment rule to going private mergers, Chancellor Strine noted that:

- "the effect of using both protective devices is to make the form of the going private transaction analogous to that of a third-party merger under Section 251 of the Delaware General Corporation Law" with special committee approval being "akin to that of the approval of the board in a third party transaction" and the majority-of-the-minority approval replicating "the approval of all the stockholders".
- the Court's holding is "consistent with the central tradition of Delaware law, which defers to the informed decisions of impartial directors, especially when those decisions have been approved by the disinterested stockholders on full information and without coercion."
- the holding will benefit minority stockholders "because it will provide a strong incentive for controlling stockholders to accord minority investors the transactional structure that respected scholars believe will provide them the best protection" because of "the benefits of independent, empowered negotiating agents..." combined with "the critical ability to determine for themselves whether to accept any deal that their negotiating agents recommend to them."

CONCLUSION

The *MFW* decision signifies the first step by a Delaware Court to squarely address the "inconsistent" judicial record dealing with going private mergers involving controlling stockholders. To the extent that this decision is not appealed and overturned, deal makers will know with certainty that, regardless of whether a transaction is structured as a tender offer or a merger, if both procedural protections are utilized, a Court will apply the deferential business judgment rule. In such instances, a Court would be 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". This would be a stark contrast to the exacting entire fairness review under which a Court reviews the procedural and financial fairness of a merger.

Notwithstanding the obvious incentives, it remains unclear how frequently this approach may be employed given the risks associated with a majority-of-the-minority approval. For example, some may choose to simply implement only an independent, empowered special committee as its procedural protection, taking sufficient comfort in the fact that such action would "shift the burden of proof under the entire fairness standard from the defendant to the plaintiff." Alternatively, the *MFW* decision should not be read as overturning existing, "inconsistent" precedent that suggests that a controlling stockholder does not owe "the same equitable obligations when it seeks to acquire the rest of a corporation's equity by a tender offer, rather than by a statutory merger". A controlling stockholder could, therefore, determine to structure its transaction as a tender offer rather than follow the approach set forth in the *MFW* decision.

CORPORATE GOVERNANCE GROUP

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