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Delaware Chancery Court Finds Pending Derivative Action May Compromise Independence of Special Committee

Court Rules That Allegation That a Majority of the Special Committee May Have Been Motivated to Ratify Proposed Freeze-out in Order to Extinguish Underlying Derivative Litigation Risk Was Sufficient to Overcome a Motion to Dismiss.

SUMMARY

On February 26, 2020, in *In re AmTrust Financial Services, Inc. Stockholder Litigation*,[1] Chancellor Bouchard of the Delaware Court of Chancery denied a motion to dismiss claims that AmTrust's controlling stockholders and allegedly self-interested members of the AmTrust board's special committee breached their fiduciary duties in connection with a November 2018 merger in which AmTrust's controlling stockholders teamed up with a private equity firm to take AmTrust private.

The Court concluded that the complaint's allegations that the special committee had a material self-interest in the transaction because the merger would extinguish viable derivative claims in an unrelated litigation that exposed the committee members to significant personal liability were sufficient, at the pleading stage, to avoid dismissal on business judgment grounds under *Kahn* v. *M&F Worldwide Corp*. ("*MFW*").[2]

BACKGROUND

AmTrust is controlled by members of the Karfunkel-Zyskind family, three of whom served on the seven-member board of the company. In 2015, AmTrust stockholders brought derivative litigation against members of the Karfunkel-Zyskind family and four outside directors on the AmTrust board for breaching their fiduciary duties to and usurping a corporate opportunity in connection with AmTrust's and the family's

dealings with another company. The Delaware Court of Chancery denied a motion to dismiss that litigation, stating that the core allegations were "'very troubling'" and "'describe a very unusual set of circumstances.'"[3]

In November 2017, Barry Zyskind, AmTrust's Chairman and CEO, informed the Board that the Company had received calls from potential investors in response to public reports that the family was interested in taking the company private and that senior management was negotiating non-disclosure agreements with certain parties so they could commence due diligence. In January 2018, the Karfunkel-Zyskind family entered into a joint bidding agreement with private equity firm Stone Point Capital LLC and offered $12.25 per share in cash to acquire all outstanding stock. The offer was conditioned on approval by an independent special committee of the AmTrust Board and a majority of AmTrust's minority stockholders.

A special committee was formed and negotiated a revised bid of $13.50, which the committee recommended that the board approve. But the transaction was opposed by certain major stockholders, including Carl Icahn, who held more than 9.3% of AmTrust's outstanding shares and began soliciting proxies against the transaction. ISS also opposed the deal, criticizing the "less-than-robust sale process" and suggesting a valuation range between $14.35 and $20.82.[4]

On June 4, 2018, Icahn informed the Karfunkel-Zyskind family and AmTrust's financial and legal advisors that he would support a transaction at $14.75 per share. The family and Stone Point agreed to increase their price to that level subject to Icahn entering into a satisfactory support agreement, to which Icahn agreed.

On June 6, 2018, the special committee and the board approved the revised deal price and on June 21, the merger agreement was approved by 67.4% of the unaffiliated stockholders. The transaction closed on November 29, 2018.

Because only current stockholders can maintain derivative litigation on a company's behalf and all public stockholders were bought-out in the merger, the 2015 derivative litigation was essentially terminated as a result of the merger.

Between May 2018 and February 2019, Plaintiffs filed three class action complaints challenging the merger, which the Court consolidated. Defendants moved to dismiss, arguing that the transaction was subject to business judgment review under *MFW* because the transaction was from the outset conditioned on approval by an independent special committee and a vote of a majority of the minority of the unaffiliated shareholders. However, Plaintiffs countered that *MFW* was not applicable because the complaint alleged that the special committee was not sufficiently independent because its decision to support the merger was compromised by its desire to extinguish the 2015 derivative case.

THE COURT OF CHANCERY DECISION

The Court of Chancery agreed with Plaintiffs and held that the complaint sufficiently alleged that the *MFW* standard had not been satisfied. The Court explained that *MFW* requires that special committee members must not only be independent "in the sense of not being beholden to a controlling stockholder," but also "must have no disabling personal *interest* in the transaction at issue."[5] The Court then focused on the allegations that three of the four AmTrust special committee members were defendants in a derivative litigation with "'very troubling'" allegations that had survived a motion to dismiss, and "that the potential liability they faced was material to each of them personally."[6] The Court noted that the underlying derivative litigation was potentially worth "'in excess of $300 million'" and that the special committee's financial advisor had informed the committee that the "net settlement value" of that litigation was "'between $15 million and $25 million.'"[7] The Court thus reasoned that it "certainly is reasonably conceivable that the prospect of joint and several liability for a claim with a settlement value in this range—from which it is reasonable to infer the amount of the exposure was much higher—would be material" to the special committee members personally. As a result, the Court concluded that the interested members of the special committee and the Karfunkel-Zyskind family were not entitled to dismissal under *MFW*.[8]

IMPLICATIONS

This decision serves as a reminder that, even in an interested stockholder transaction, a director's independence can be compromised by circumstances other than relationships with the controlling shareholder. It would likely be an over-read of the opinion to conclude that the existence of any derivative litigation would automatically compromise director's independence, but *AmTrust* reinforces the point that independence requires an inquiry into more than just the relationship of directors with the actual parties to a transaction.

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ENDNOTES

[1] 2020 WL 914563 (Del. Ch. Feb. 26, 2020).

[2] 88 A.3d 635 (Del. 2014).

[3] 2020 WL 914563, at *3.

[4] *Id.* at *6.

[5] *Id.* at *10.

[6] *Id.* at *11.

[7] *Id.*

[8] The Court did not reach the question of whether *MFW* would have applied even though the final price bump was negotiated by a shareholder and not the special committee.

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