June 3, 2013

In re MFW Shareholders Litigation

Controlling Stockholder's Upfront Commitment to *Both* Approval by Special Committee *and* Majority-of-the-Minority Vote Warrants Business Judgment Rule Standard of Review For Freeze-Out Mergers

SUMMARY

In an opinion issued on May 29, 2013, the Delaware Court of Chancery (Strine, C.) held that the business judgment rule standard of review applies to freeze-out mergers with controlling stockholders so long as from the outset of the merger negotiations the controlling stockholder commits to proceed with the merger only if it is subject to *both* (1) negotiation and approval by a special committee of independent directors free to select its advisors and empowered to say no definitively *and* (2) approval by an *uncoerced*, fully informed vote of a majority of the minority.[1]

MFW is the first Delaware opinion holding that entire fairness is not always the appropriate standard of review for a freeze-out merger. Until *MFW*, the only variable in judicial review of a freeze-out merger was whether the controlling stockholder had employed sufficient procedural safeguards to shift to the plaintiff the burden of proof on entire fairness—which it could do if the target company created a well-functioning special committee to evaluate and negotiate the bid *or* the transaction was subject to a non-waivable majority-of-the-minority stockholder vote.

Finding that the Delaware Supreme Court's precedents arguably left open what the effect of employing *both* safeguards would be, Chancellor Strine held that freeze-out mergers with *both* safeguards do more than simply shift the burden of proof on the substantive issue of entire fairness; they shift the standard of review itself. In so holding, Chancellor Strine conceded that his holding is not free from doubt and, in any event, subject to confirmation or rejection by the Delaware Supreme Court, if appealed.

The *MFW* opinion, Chancellor Strine noted, provides controlling stockholders with an incentive to effect going private transactions through a merger instead of the "inherently more coercive" tender offer by

allowing them to benefit from the less rigorous standard of review, and thereby giving them a strong basis to dismiss at the pleading stage the inevitable shareholder litigation challenging the merger. Presently, settling litigation over freeze-out mergers is an almost foregone conclusion because of the high costs of discovery and inherent unpredictability of the outcome resulting from entire fairness review.

As the Court itself emphasized, however, the presumptions of the business judgment rule now provided under *MFW* are available *only* if (1) the controller from the outset conditions the transaction on the approval of both a special committee and a majority of the minority stockholders; (2) the special committee is independent; (3) the special committee is broadly empowered, including to freely select its own advisors and to say no definitively; (4) the special committee meets its duty of care; (5) the minority vote is informed; and (6) the minority is not coerced. Failure to satisfy any one of these conditions would subject the defendants to entire fairness review.

It is not clear whether all controlling stockholders will attempt to take advantage of the application of business judgment rule review given the attendant risks that the stockholder vote might fail or that a process defect might trigger post-closing entire fairness review anyway. Some controllers may continue to prefer the certainty of merger approval and the attendant litigation settlement costs invariably required by entire fairness cases. Nevertheless, *MFW* reinforces the importance of ensuring that a special committee adheres to the procedural strictures it would follow if entire fairness were being applied.

BACKGROUND

In June 2011, when the stock of M&F Worldwide ("MFW") was trading at less than $17 per share,[2] MacAndrews & Forbes proposed to the MFW board (and publicly disclosed the next day) to acquire the approximately 56% of MFW it did not already own for $24 per share in cash. In its proposal, MacAndrews & Forbes said that (1) it would not move forward with the transaction unless it was approved by a special committee, (2) the transaction would be subject to a non-waivable condition requiring the approval of a majority of MFW shares it did not own, (3) it was not a seller, and (4) if the transaction were not so approved, it intended to remain a long-term stockholder.

MFW promptly formed a special committee ultimately comprising four directors empowered to investigate and evaluate the proposal, negotiate with MacAndrews & Forbes, retain its own advisors, and determine to elect not to pursue the proposal. The special committee and the legal and financial advisors it retained met eight times over the summer of 2011. Among other things, the special committee evaluated a full range of financial information about MFW and considered MFW's other strategic options, including whether other buyers might be interested in purchasing MFW if MacAndrews & Forbes were willing to sell its shares and possible asset divestitures, that might generate more value for the minority stockholders than a sale to MacAndrews & Forbes. After rejecting MacAndrews & Forbes's initial $24 offer and countering at $30 per share, the special committee ultimately extracted a $1 per share increase to the merger price. Having received a fairness opinion from its financial advisor, the committee unanimously recommended the $25 per share transaction (representing a 47% premium over MFW's trading price the day before MacAndrews & Forbes made its proposal) to the full MFW board, which (except for representatives of MacAndrews & Forbes and members of management, who recused themselves) also approved it unanimously. Approximately 65% of the shares not owned by MacAndrews & Forbes voted in favor of the merger, which closed on December 21, 2011.

Before the vote, unaffiliated stockholders of MFW filed suit against MacAndrews & Forbes, Ron Perelman (MacAndrews & Forbes's sole stockholder) and MFW's directors, alleging that the deal was unfair and that the Court should enjoin the transaction before the stockholder vote. The plaintiffs ultimately dropped their injunction request and asked instead for a post-closing damages remedy for breach of fiduciary duty based on their allegation that the transaction was not entirely fair. For their part, the defendants moved for summary judgment on the grounds that their use of both procedural protections—*i.e.*, approval by an independent special committee and a majority-of-the-minority stockholder vote—replicated an arm's length merger and therefore entitled them to the presumptions of the business judgment rule. Under that standard, the defendants claimed, they were entitled to summary judgment so long as the merger was one that a rational person acting in good faith could believe was fair to MFW's minority stockholders.

THE COURT'S DECISION

In determining that the defendants were entitled to summary judgment, the *MFW* Court found that the independent special committee process and the non-waivable majority-of-the-minority merger vote condition qualified as "cleansing devices," reasoned that application of the business judgment rule in these circumstances would, overall, create incentives benefiting minority stockholders, and ultimately concluded that the plaintiffs had failed to rebut the presumptions of the business judgment rule that the MFW merger was the product of reasoned, good faith business judgment. The *MFW* decision harmonizes the standard of judicial review of freeze-out mergers with that of judicial review of freeze-out tender offers, thereby addressing the doctrinal inconsistency that had been commented on unfavorably in dicta in previous Chancery Court decisions.[3]

A. *The Special Committee Was Empowered and Independent, and It Satisfied its Duty of Care*

The Court first found that it was undisputed that the special committee had a clear mandate to retain its own independent advisors, and to evaluate and negotiate MacAndrews & Forbes's proposal, and that it had done so. As the Court emphasized, "[c]ritically, this negotiating power was accompanied by the clear authority to say no *definitively* to MacAndrews & Forbes."[4] Because MacAndrews & Forbes had promised that it would not proceed without approval from a special committee, the Court said that the special 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. Rather, the special committee was fully empowered to say no and make that decision stick."[5] While the Court noted there were remedies at law for controllers who fail to adhere to their commitments, it is not clear from the opinion how long the Court believed MacAndrews & Forbes would be precluded by its commitment from commencing a tender offer if its merger proposal had been rejected. The Court further noted that the special committee also had the authority, which it exercised, to evaluate other strategic options.[6]

Secondly, the Court found that each member of the special committee was "independent" under Delaware law.[7] Citing well-established precedents, the Court noted that for a director not to be "independent" he or she must be found to have "material" ties (whether financial or personal considering the particular director's relevant circumstances) to the person whose actions he or she is evaluating that are "sufficiently substantial that she cannot objectively fulfill her fiduciary duties."[8] Specifically, the Court found that the special committee members' tangential personal relationships with Ron Perelman were immaterial as were, among others, consulting fees a committee member had received four years earlier from MacAndrews & Forbes in the range of $100,000, and $200,000 in legal fees that one committee member's law firm had received from 2009 to 2011 for advising MacAndrews & Forbes; the Court noted that the plaintiffs failed to proffer evidence concerning the financial position of each committee member sufficient to demonstrate that such fees might have been material to the particular director.

Thirdly, the Court found that the plaintiffs failed to show that the special committee had not satisfied its duty of care. Among other things, the Court noted that the committee (a) interviewed four prospective financial advisors before retaining and receiving independent advice from a competent advisor, (b) reviewed financial projections prepared by management in the ordinary course and sought updates to those projections to reflect the most current management views,[9] (c) considered alternatives to MacAndrews & Forbes's proposal, including divestitures and whether there were other buyers (assuming MacAndrews & Forbes would be amenable to that alternative even though they had said they were not), (d) counteroffered MacAndrews & Forbes's proposal and extracted an increase in the deal price,[10] (e) received analyses showing that the deal price fell within the range of DCF and premiums paid analyses performed by its financial advisor, and (f) formally met eight times over three months. The Court noted that because the special committee was comprised of independent directors there was no basis to infer that they did not act in good faith to obtain the best price they could for the minority stockholders.

Notably, the Court also stated that it was not assessing whether the special committee was "effective" in the sense of "being substantively good at its appointed task" (*i.e.*, obtaining a good economic result), which, according to the Court, "involves the sort of second-guessing that the business judgment rule precludes."[11] Rather, the Court said, so long as "a committee is structurally independent, has a sufficient mandate and cannot be bypassed, and fulfills its duty of care, it should be given standard-shifting effect."[12]

B. *A Fully Informed, Uncoerced Majority of the Minority Supported the Deal*

The Court allocated little discussion to finding that the stockholder vote was fully informed—facts that "the plaintiffs themselves [did] not dispute"[13]—based on the fulsome disclosures made by MFW in its proxy statement disseminated in connection with the merger.

The Court emphasized repeatedly, however, the importance of not simply having a majority-of-the-minority stockholder vote, but that the condition of such a vote be established at the initiation of the process and that the vote be uncoerced. As the Court articulated the point, only when *both* protections are "established up-front" will the controlling stockholder know "[f]rom inception . . . that it cannot bypass the special committee's ability to say no" or merely "dangle a majority-of-the-minority vote before the special committee late in the process as a deal-closer rather than having to make a price move."[14] Because MacAndrews & Forbes's initial proposal made clear that it could not bypass either procedural safeguard, the Court found that the proposal provided the minority with a truly uncoerced opportunity to accept or reject the merger via the stockholder vote.

C. *Business Judgment Rule Applies to Controller Merger Freeze-Outs Conditioned on Two Procedural Safeguards*

The Court concluded after a careful review of previous Delaware Supreme Court and Court of Chancery decisions, including what it considered to be dicta on the topic, that no case squarely had addressed the appropriate standard of review—business judgment rule or entire fairness—applicable to a controller-led freeze-out merger that employed *both* procedural safeguards. It also reviewed the fact that Delaware courts have applied different standards of review to controlling stockholder freeze-out transactions depending on the structure—merger or tender offer—employed. The Court noted that there has been no incentive for controllers to opt for both procedural protections in the one step merger context since the controllers get no credit for employing both. Citing academic research suggesting that a combination of an independent committee negotiating agent with the power to say no and a majority-of-the-minority vote is the structure most protective of minority interests, the Court concluded that applying business judgment rule review to controlling stockholder freeze-out merger transactions would benefit minority stockholders.

In the Court's view, the "both" safeguard structure replicates the arm's length merger steps statutorily prescribed by the DGCL, *viz.* requiring two independent approvals in which the controlling stockholder first negotiates with independent directors and then obtains approval from a majority of unaffiliated stockholders. And, in its view, employing both safeguards greatly enhances the minority stockholders' voice—the special committee, aware that it will be judged by the minority stockholders, may bargain harder,[15] while the controlling stockholder, wanting a favorable vote, may be willing to concede more. Noting that a special committee alone deprives stockholders of the chance to protect themselves and that a majority-of-the-minority vote alone deprives stockholders of the benefits of an independent bargaining agent working on their behalf, the Court stated that "[t]hese protections are therefore incomplete and not substitutes, but are complementary and effective in tandem."[16]

The Court also noted that the "both" structure in which the controller promises not to bypass the special committee or the majority-of-the-minority vote limits the threat of retaliation or other coercive tactics by the controlling stockholder if the minority stockholders vote down the merger. "Precisely because the controller can only get business judgment rule treatment if it foregoes the chance to go directly to stockholders, any potential for coercion is minimized," the Court stated.[17] In that respect, the Chancellor noted significant and powerful changes in the capital markets since the Delaware Supreme Court in *Kahn v. Lynch Communications Systems, Inc.* held that freeze-out mergers are subject to entire fairness, changes that have increased the willingness of stockholders to speak up, including the increasing concentration of equities held by institutional investors with demonstrated willingness to vote against management-sponsored proposals and facilitating the assembly of blocking positions by minority investors, and the influence of voting advisors such as ISS and Glass Lewis to discipline directors after-the-fact by recommending withhold votes or by supporting (an increasing number of) proxy contests. Coupled with "the potency of remedies available under [Delaware] law and statutory protections that prevent controlling stockholders from discriminating against minority stockholders,"[18] the Court concluded that an "upfront promise not to bypass the special committee or the majority-of-the-minority condition limits the potential for any retributive going private effort."[19]

Lastly, the Court noted that the additional protection that entire fairness review might provide in freeze-out mergers is outweighed by the considerable costs it imposes. The fact-intensive nature of entire fairness review makes it practically impossible to dismiss claims at the pleadings stages, giving plaintiffs' firms considerable leverage to extract attorneys' fees from nonmonetary settlements that the Court noted not only do not benefit minority stockholders, but actually force them to bear costs "in the form of higher D&O insurance fees and other costs of capital to issuers that reduce the return to diversified investors."[20]

D. *Summary Judgment Is Appropriate Under the Business Judgment Rule*

Once the Court determined to apply the business judgment rule, it gave short shrift to any contention that the defendants were not entitled to summary judgment. "If the business judgment rule standard of review applies, the claims against the defendants must be dismissed unless no rational person could have believed that the merger was favorable to MFW's minority stockholders," the Court stated.[21] Among other indicia the Court cited for showing that the merger could be the product of a rational business judgment were the 47% premium offered by the merger, the financial advisor's fairness opinion, and the fact that 65% of the minority stockholders voted in favor of the merger. "Although the plaintiffs raise arguments as to why the merger should have been at a higher price, these arguments, and the scant facts supporting them, do not raise a triable issue of fact under the business judgment rule," the Court wrote.[22] The Court went on to suggest that when a stockholder can find no fault in the board's process but merely is dissatisfied with the ultimate price agreed to, the appropriate vehicle with which to assert the plaintiffs' challenges is an appraisal proceeding.

IMPLICATIONS

By creating a path for business judgment level review, the *MFW* opinion provides a means for effecting minority freeze-out mergers with substantially greater outcome certainty and likely lower transaction friction costs (time, litigation expenses, etc.) for the controllers than previously was possible.

The *MFW* decision, if appealed, will receive careful scrutiny from the Delaware Supreme Court and because, as even Chancellor Strine noted in his opinion, rational minds can differ on this issue, the Delaware Supreme Court may not uphold the *MFW* decision or otherwise endorse its approach.

MFW contemplates a precise procedural framework designed to protect minority stockholders; failure to adhere to that precise framework—*e.g.*, by not conditioning the transaction from inception on a majority-of-the-minority stockholder vote, failing to endow the special committee with full authority to say no definitively, or permitting beholden directors to serve on the special committee—will preclude application of the business judgment rule and subject a transaction to onerous entire fairness review.

MFW does not undo existing Delaware precedent permitting a burden shift in entire fairness review for transactions that have the benefit of either an independent committee recommendation *or* a majority-of-the-minority condition, and some transactions may continue to be structured in this manner, particularly if there is uncertainty about obtaining minority approval or a controlling stockholder is willing to withstand the litigation costs of entire fairness review. But it does, at least for now, effectively harmonize the standard of judicial review applicable to freeze-out transactions whether effected through tender offers or mergers.

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ENDNOTES

1 *In re MFW S'holders Litig.*, C.A. No. 6566-CS, slip op. at 7 (Del. Ch. May 29, 2013) [hereinafter *Slip Op.*].

2 In May 2011, MFW stock had been trading at $20 to $24.

3 Commenting in dicta in *In re Cox Commc'ns, Inc. S'holders Litig.*, 879 A.2d 604, 606 (Del. Ch. 2005), then-Vice Chancellor Strine suggested that the divergent doctrines could and should be harmonized. Vice Chancellor Laster attempted to do so in *In re CNX Gas Corp. S'holders Litig.*, 4 A.3d 397 (Del. Ch. 2010) but, because he ultimately found the special committee too impotent to invoke business judgment rule review, his comments in this respect also may be considered dicta.

Under *Kahn v. Lynch Commc'ns Sys., Inc.*, 638 A.2d 1110 (Del. 1994) and its progeny, controlling stockholder freeze-out mergers always are subject to entire fairness review, but use of one procedural safeguard can shift the burden of proof on entire fairness to the plaintiff. By contrast, under *In re Siliconix Inc. S'holders Litig.*, 2001 WL 716787 (Del. Ch. June 21, 2001), controller-led two-step tender offers are reviewed under the business judgment rule, provided they are not "coercive." The meaning of "coercive" in this context is subject to "an evolving standard" but that, in any case, is "far less onerous than *Lynch*." *CNX Gas*, 4 A.3d at 406. The Delaware Court of Chancery has held that a tender offer by a controlling stockholder is not coercive if (1) it is subject to a non-waivable majority-of-the-minority tender condition, (2) the offeror promises to complete a short form merger at the completion of the offer at the same price if it obtains more than 90% of the shares, (3) "the controlling stockholder has made no retributive threats," and (4) the controlling stockholder allows the special committee "both free reign and adequate time to react to the tender offer." *In re Pure Res., Inc. S'holders Litig.*, 808 A.2d 421, 445 (Del. Ch. 2002).

In *Cox Commc'ns*, Strine "rendered the *Lynch* and *Siliconix* standards coherent by explaining that the business judgment rule should apply to any freeze-out transaction that is structured to mirror *both* elements of an arms' length merger, *viz*. approval by disinterested directors *and* approval by disinterested stockholders" because, doctrinally, if the controller effectively stands "only on one side of the transaction—as the buyer—[then] entire fairness [is] inapplicable." *CNX Gas*, 4 A.3d at 412.

4 *Slip Op.* at 17 (emphasis added).

5 *Id.*

6 The Court recognized that, as a "practical" matter, the committee could not "market MFW to other buyers." *Id.* In its capacity as a stockholder, "MacAndrews & Forbes had no duty to sell its block . . . unless it decided to become a seller." *Id.* Nevertheless, the Court credited the special committee for instructing its financial advisor to study whether other strategic options were available to MFW if MacAndrews & Forbes were willing to sell.

7 The Court noted that "the plaintiffs fail[ed] to argue that any of the members of the special committee did not meet the specific, detailed independence requirements of the NYSE," which they presumably qualified under since they were serving as independent directors of an NYSE-listed public company. Although the definition of independence under Delaware law varies in certain respects from that of the federal securities laws and stock exchange listing rules, the Court noted that the NYSE standards for independence "were influenced by experience in Delaware . . . . They cover many of the key factors that tend to bear on independence, including whether things like consulting fees rise to a level where they compromise a director's independence, and they are a useful source for this court to consider when assessing an argument that a director lacks independence" *Id.* at 21.

8 *Id.* at 20.

ENDNOTES (CONTINUED)

[9] The Court noted that the updated projections forecast EBITDA for MFW of $491 million in 2015, as opposed to $535 million under the original projections. *Id.* at 29.

[10] The Court also noted that, in obtaining this increased deal price, the special committee actually had countered MacAndrews & Forbes's $24 offer with $30 per share, which MacAndrews & Forbes initially rejected out of hand. Only when the chairman of the special committee informed MacAndrews & Forbes that he would not recommend $24 per share to the special committee did MacAndrews & Forbes "obtain[] approval from Perelman to make a 'best and final' offer of $25 a share." *Id.* at 30.

[11] *Id.* at 34-35.

[12] *Id.* at 35.

[13] *Id.* at 34.

[14] *Id.* at 53.

[15] *See id.* at 54 ("[M]ost directors will want to procure a deal that their minority stockholders think is a favorable one, and virtually all will not want to suffer the reputational embarrassment of repudiation at the ballot box." (citing empirical evidence of the increasing effectiveness of withhold campaigns to discipline directors for their conduct on *any* of the various boards on which they might sit)).

[16] *Id.* at 8.

[17] *Id.* at 9.

[18] *Id.* at 61.

[19] *Id.* at 60.

[20] *Id.* at 64.

[21] *Id.* at 36.

[22] *Id.* at 36-37.

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