

# CLIENT UPDATE

## DELAWARE SUPREME COURT APPLIES BUSINESS JUDGMENT REVIEW TO CONTROLLING STOCKHOLDER MERGERS USING DUAL PROTECTION STRUCTURE

### NEW YORK

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The Delaware Supreme Court today affirmed the Court of Chancery's May 2013 decision in *In re MFW Shareholders Litigation*, holding that a going private merger with a controlling stockholder will be subject to the business judgment rule, rather than the far more rigorous test of entire fairness, if the transaction is conditioned from its inception on (1) approval by an independent and fully empowered special committee of directors and (2) the uncoerced, informed vote of a majority of the shares held by persons unaffiliated with the controlling stockholder (a so-called majority-of-the-minority vote).

The Court accepted the premise of then-Chancellor, now-Chief Justice, Strine, author of the Court of Chancery opinion (who did not participate in the Supreme Court's decision), that the case presented a question of first impression. Previously, the Delaware Supreme Court had consistently applied the entire fairness standard of review to all mergers where controlling stockholders were part of the acquiring group. Although the Court held in *Kahn v. Lynch* that the burden shifts to the plaintiff to show that a merger with a controlling stockholder was not entirely fair if the transaction was approved by either a special committee of independent directors or a majority-of-the-minority stockholder vote, neither *Lynch* nor any of the cases following it where a controlling stockholder stood on both sides of the transaction involved a transaction subject to both procedural protections (special committee approval and majority-of-minority vote). The Court called this a "vital distinction."

The Court articulated four reasons for holding that business judgment is the appropriate standard of review where both procedural protections are implemented. First, while entire fairness review acts as a substitute in the controlling shareholder context for the protections of disinterested board and stockholder approval, which may be undermined by the controller's influence, "that undermining influence does not exist in every controlled merger setting." Where the controller "irrevocably and publicly disables itself from using its control to dictate the outcome," the controller merger resembles a third-party, arm's-length merger, which is reviewed under the business judgment standard. Second, the dual protection structure "optimally protects" the minority stockholders by providing "a potent tool to extract good value for the minority." Third, adoption of the business judgment standard is consistent with Delaware law's tradition of deferring to the informed decisions of impartial directors, particularly where ratified by the approval of disinterested stockholders, and will encourage controlling stockholders to provide these protections to minority stockholders. Fourth, the underlying purposes of entire fairness review and the dual protection structure – ensuring a fair price – are consistent.

The Court emphasized that to be eligible for business judgment review, a controller buyout must satisfy each of the following conditions:

- the controller from the beginning must condition the transaction on the approval of both a special committee and a majority of the minority stockholders;
- the special committee must be independent;
- the special committee must be empowered to select its own advisors and to say no definitively;
- the special committee must meet its duty of care in negotiating a fair price;
- the vote of the minority must be informed; and
- there must be no coercion of the minority.

According to the Court, a plaintiff will be entitled to discovery if it can plead a "reasonably conceivable" set of facts showing that a transaction falls short of any of these conditions. If, after discovery, there remain triable issues of fact as to whether the conditions were satisfied, the case will proceed to trial under an entire fairness review. This apparently means that if the defendants do not succeed in obtaining summary judgment on the applicability of the business judgment standard, they will not be allowed to show at trial that these conditions in fact were satisfied and that the business judgment standard should be applied.

After reviewing the facts underlying the Court of Chancery's decision in *MFW*, the Supreme Court agreed that all the conditions for applying the business judgment standard had been satisfied and affirmed the judgment dismissing the plaintiffs' claims.

The Delaware Supreme Court's decision provides welcome clarity in this previously uncertain area of law, and should encourage controlling stockholders to avail themselves of the roadmap the Court has provided for obtaining business judgment review of going private mergers.

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Please do not hesitate to contact us with any questions.

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