MORRIS NICHOLS ARSHT & TUNNELL

Delaware Corporate Law Counseling Group
Corporate & Business Litigation Group
ALERT

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SUPREME COURT UPHOLDS APPLICATION OF BUSINESS JUDGMENT RULE TO FREEZE-OUT MERGERS EMPLOYING DUAL MINORITY PROTECTIONS

In *Kahn v. M&F Worldwide Corp.,* issued on March 14, 2014, the Delaware Supreme Court addressed "a question of first impression: what should be the standard of review for a merger between a controlling stockholder and its subsidiary, where the merger is conditioned *ab initio* upon the approval of **both** an independent, adequately-empowered Special Committee that fulfills its duty of care, and the uncoerced, informed vote of the minority stockholders." Affirming the Court of Chancery's decision in *In re MFW Shareholders Litigation*, the Supreme Court held that the business judgment rule applies. **Click here** to download a copy of the Court's opinion.

By default, a merger that squeezes out minority stockholders is subject to "entire fairness" review because of the transaction's inherent self-dealing. Twenty years ago, the Supreme Court held in *Kahn v. Lynch Communication Systems, Inc.*, that the use of *either* a potent special committee *or* a majority-of-the-minority vote can shift the burden of proof to the plaintiffs, but entire fairness remains the applicable standard. The question of what standard ought to apply if the merger employs *both* safeguards, however, "has never been put directly to [the Supreme] Court."

The Supreme Court concluded that the business judgment rule is appropriate "for several reasons." First, entire fairness applies by default "as a substitute for the dual statutory protections of disinterested board and stockholder approval," but "simultaneous deployment" of both safeguards "create a countervailing, offsetting influence of equal force." Second, this structure "optimally protects the minority stockholders" by creating a "potent tool" from which the special committee can extract value from the controller, *viz.*, the committee's ability to say no and the controller's inability to "dangle a majority-of-the-minority vote . . . late in the process as a deal-closer rather than having to make a price move." Third, this approach "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." And fourth, like the "underlying purpose" of entire fairness review, it requires judicial scrutiny of price; to invoke the business judgment rule, a court must make "two price-related pretrial determinations" that a fair price was achieved by a fully functioning independent committee and that the minority approved that price by a fully-informed, uncoerced vote.

Six prerequisites are necessary to invoke the business judgment rule: (i) the controller conditions "procession of the transaction" on both safeguards; (ii) the committee is independent; (iii) the committee is empowered to select its own advisors and to say no definitively; (iv) the committee meets its duty of care in negotiating a fair price; (v) the minority vote is informed; and (vi) there minority vote is uncoerced. Unless these prerequisites "are established *prior to trial*, the ultimate judicial scrutiny of controller buyouts will continue to be the entire fairness standard of review." The Supreme Court also observed that "allegations about the sufficiency of the price call into question the adequacy of the Special Committee's negotiations," thereby potentially precluding a motion to dismiss.

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