RECENT CASES


Delaware courts have traditionally subjected going-private mergers\(^1\) to entire fairness review,\(^2\) with the burden on controlling-shareholder defendants to demonstrate that such “freezeout” transactions are entirely fair to minority shareholders. In 1994, the Delaware Supreme Court held that defendants can shift the burden of persuasion under entire fairness review to plaintiffs if the defendants show that the transaction was either (i) negotiated by a well-functioning special committee of independent directors or (ii) conditioned on the approval of a majority of the minority shareholders.\(^3\) The applicable standard of review for transactions employing both procedural devices, however, remained an open and contested question. Recently, in Kahn v. M&F Worldwide Corp.,\(^4\) the Delaware Supreme Court held that freezeout mergers structured with these dual protections should be reviewed under the highly deferential business judgment standard.\(^5\) While M&F Worldwide resolved open doctrinal and policy questions, it remains to be seen how the decision will affect transactional practice — and, specifically, whether it will create the intended incentives for controlling shareholders and the desired safeguards for minority shareholders.

In June 2011, MacAndrews & Forbes Holdings, Inc. (M&F), a 43% controlling shareholder of its subsidiary, M&F Worldwide Corp. (MFW), proposed to acquire MFW for $24 per share in cash.\(^6\) M&F conditioned the transaction on approval by both (i) a special committee composed of independent MFW directors and (ii) a majority of minority MFW shareholders (those unaffiliated with M&F).\(^7\) The special committee picked its own advisors, negotiated with M&F, and induced M&F to raise its bid to $25 per share.\(^8\)

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1. In a going-private merger, a corporation’s controlling shareholder attempts to buy the remainder of the corporation’s widely held shares from minority shareholders using the mechanism of a “statutory merger.” See DEL. CODE ANN. tit. 8, § 251(a)-(c) (2011).
2. Entire fairness — fair dealing and fair price — is the highest level of scrutiny used in takeover challenges; it requires courts to evaluate the fairness of both the process of a transaction (its timing, structure, negotiation, disclosure, and approval) and its substance (via the court’s own valuation assessment). See Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983).
4. 88 A.3d 635 (Del. 2014).
5. Id. at 644.
6. Id. at 638, 640.
8. Id.
minority vote ultimately approved the merger, which closed in December 2011. Shareholders of MFW who had not voted to approve the transaction promptly sued in the Delaware Court of Chancery for damages for breach of fiduciary duty. M&F moved for summary judgment. Chancellor Strine granted M&F’s motion for summary judgment, determining that business judgment review applied to a going-private merger “conditioned upfront by the controlling stockholder on approval by both a properly empowered, independent committee and an informed, uncoerced majority-of-the-minority vote.” Chancellor Strine began by considering two preliminary questions: first, whether MFW’s special committee and majority-of-the-minority protections qualified as adequate “cleansing devices” under Delaware law and second, whether the Delaware Supreme Court had previously resolved the standard of review issue. Chancellor Strine answered the first question in the affirmative: the special committee consisted entirely of independent directors, hired its own advisors, had “clear authority” to reject M&F’s offer “definitively,” considered other strategic options, and negotiated in good faith, while the “majority-of-the-minority vote was fully informed and uncoerced.” As to the second question, Chancellor Strine concluded that existing case law did not provide a standard of review. Although prior decisions had applied entire fairness review to merger freezeouts subject only to special committee approval, no case had determined the appropriate standard of review for merger freezeouts subject to both procedural protections.

Proceeding to the “core legal question,” Chancellor Strine advanced several justifications for business judgment review. First, Del-
aware law had long deemed it “beneficial to investors for courts, which are not experts in business, to defer to the disinterested decisions of directors, who are expert, and stockholders, whose money is at stake.”

Since the dual-protection structure replicated the features of the disinterested, arm’s-length merger process, deferential business judgment review would be consistent with Delaware’s traditional approach. Second, the availability of business judgment review and dismissal on the pleadings would create a “strong incentive” for controlling shareholders to use both procedural devices, which in turn would give “minority stockholders much broader access to the transactional structure that is most likely to effectively protect their interests.”

Third, allowing business judgment review of freezeout mergers with dual protections would help address an inconsistency in Delaware law: lower courts already applied the business judgment rule to freezeouts structured as tender offers if they met similar requirements. In closing, Chancellor Strine acknowledged a cost to minority shareholders: they would no longer be able to use the threat of entire fairness review as a bargaining chip for a higher price or for settlement leverage. He determined, however, that this cost was negligible and did not outweigh the benefits of an incentive structure that would encourage the use of both protections.

Finding that the merger met the business judgment standard, Chancellor Strine granted M&F’s motion for summary judgment. The MFW minority shareholders appealed.

The Delaware Supreme Court, sitting en banc, unanimously affirmed. Writing for the court, Justice Holland began by confirming that the standard of review question was one of first impression.

20 Id. at 526 (emphasis added).
21 Id. at 528.
22 Id. With both protections in place from the outset, the controlling shareholder can neither bypass the special committee nor offer a majority-of-the-minority condition later in the process as a bargaining chip in lieu of increasing the offer price; the special committee, in turn, is free to negotiate aggressively with the controller. Id.
23 Id. at 535–36; see also, e.g., In re CNX Gas Corp. S’holders Litig., 4 A.3d 397 (Del Ch. 2010); In re Pure Res., Inc., S’holders Litig., 808 A.2d 421 (Del. Ch. 2002). In a tender offer freezeout, the controlling shareholder makes an offer directly to minority shareholders to purchase their shares rather than using the formal statutory merger mechanism.
24 See MFW, 88 A.3d at 634.
25 Id. at 534–35. In support of this proposition, Chancellor Strine argued that the “systemic benefits” of entire fairness review in such cases are “slim to non-existent,” id. at 534, and he noted that empirical evidence tended to show that “the bargaining power of the special committee is what drives the consideration paid in going private transactions, not the standard of judicial review,” id. at 534 n.176 (citing In re Cox Commc’n’s, Inc. S’holders Litig., 879 A.2d 604, 626–54 (Del. Ch. 2005)).
26 Id. at 536.
27 M&E Worldwide, 88 A.3d at 638.
28 Justice Holland was joined by Justices Berger, Jacobs, and Ridgely, and by Judge Jurden of the Delaware Superior Court, sitting by designation.
29 M&E Worldwide, 88 A.3d at 642.
The court then held that business judgment was the appropriate standard of review for several reasons. First, Justice Holland explained that the "simultaneous deployment" of the special committee and majority-of-the-minority safeguards obviated the need for entire fairness review; with both procedural devices, the transaction "acquires the shareholder-protective characteristics of third-party, arm's-length mergers, which are reviewed under the business judgment standard." Second, the court agreed with the Chancery Court that the dual-protection merger structure "optimally protects the minority stockholders" and that the application of the business judgment standard was consistent with Delaware law's tradition of deferring to the decisions of disinterested, informed directors. Finally, the court reasoned that the special committee and majority-of-the-minority protections together effectuated the fundamental objective of entire fairness review: fair price.

The court concluded by specifying six necessary conditions for invoking the business judgment rule in freezeout mergers:

(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 in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.

If a plaintiff pled a "reasonably conceivable set of facts" showing that any of the six conditions did not obtain, the complaint would survive a motion to dismiss and the case would proceed to discovery. Applying this standard, the court determined, based on the "highly extensive" pretrial record, that the Chancery Court properly granted summary judgment.

It is helpful to analyze the M&F Worldwide decision and its probable effects along three separate but related dimensions. First, as a matter of corporate law doctrine, the opinion helped resolve a longstanding discrepancy in Delaware's treatment of functionally similar transactional forms. Second, M&F Worldwide clarified the policy

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30 Id. at 644. In fact, the court held, the dual protections are strong enough to "create a countervailing, offsetting influence of equal — if not greater — force" than the influence of the self-interested controller. Id. at 645.
31 See id.
32 See id. at 644–45.
33 Id. at 645.
34 Id. The court added that "if, after discovery, triable issues of fact remain about whether either or both of the dual procedural protections were established . . . [or] effective, the case will proceed to a trial in which the court will conduct an entire fairness review." Id. at 645–46.
35 Id. at 654. In so determining, the court affirmed the Chancery Court's holding that the MFW special committee was independent, empowered, and exercised due care, and that the majority-of-the-minority vote was informed and uncoerced. See id. at 646–54.
rationale for selecting standards of review for different transactional structures. Third, however, the opinion may have increased already existing uncertainty about how the standard will work in practice.

As a straightforward matter of doctrine, *M&F Worldwide* took a predictable step toward correcting the “incoherence” in Delaware law that arose from “treat[ing] economically similar transactions as categorically different simply because the method by which the controlling stockholder proceeds varies.”36 As Chancellor Strine noted, for at least the past fifteen years, lower courts have subjected freezeouts executed via tender offer, rather than via statutory merger, to business judgment review rather than entire fairness review.37 In dictum, Chancellor Strine had previously recommended eliminating this disparity by simultaneously relaxing the standard of review for merger freezeouts under certain circumstances — which *M&F Worldwide* accomplished — and strengthening the standard of review for tender offer freezeouts.38 Academics and other judges had similarly urged the adoption of a “unified standard” for all freezeouts.39

The devil is in the details, of course, and not everyone agreed on precisely how to level the playing field between merger and tender offer freezeouts.40 *M&F Worldwide*, however, when read together with tender freezeout cases in the Court of Chancery, suggests that the court wants to encourage controllers, regardless of whether they proceed by merger or tender offer, to replicate arm’s-length transactions. Chancery cases have already moved tender offer freezeout doctrine in that direction. Since tender offer freezeouts, unlike merger freezeouts, are not formally self-dealing — the controller stands on only one side of the transaction and minority shareholders can refuse to tender their shares41 — earlier Chancery cases focused on simply preventing out-
right coercion of shareholders. Both judges and commentators, however, came to recognize that controllers may nonetheless exercise undue influence over minority shareholders’ choice whether to tender, and commentators marshaled empirical evidence suggesting that minority shareholders routinely received less (in terms of premium over market price) in tender-offer freezeouts than in merger freezeouts. Later Chancery cases, perhaps in response to commentary, shifted to encouraging tender-offer freezeouts to use procedural devices that mimic arm’s-length transactions, which tend to force controllers to peg their valuation of subsidiaries to intrinsic value rather than to manipulable market price. In M&F Worldwide, the Delaware Supreme Court seems to have embraced the “replicate an arm’s-length transaction” rationale and its underlying policy — namely, that a virtual arm’s-length transaction forces a sufficiently fair valuation and precludes the need for independent valuation by the court. Although the court did not explicitly address the question of a fully unified standard of review for both kinds of freezeouts, it will likely continue


43 For example, the controller can threaten to withhold dividends if minority shareholders do not tender, see Pure Res., 808 A.2d at 436 n.18 (quoting Kahn v. Lynch Commc’n Sys., Inc., 638 A.2d 1110, 1116 (Del. 1994)), or, more subtly, can manipulate the market price of the target company’s stock, see Subramanian, supra note 37, at 32.

44 See Guhan Subramanian, Post-Siliconix Freeze-Outs: Theory and Evidence, 36 J. LEGAL STUD. 1, 23 (2007); see also Fernán Restrepo, Do Different Standards of Judicial Review Affect the Gains of Minority Shareholders in Freeze-Out Transactions? A Re-examination of Siliconix, 3 HARV. BUS. L. REV. 321, 356 (2013). Furthermore, arm’s-length tender offers — those outside the freezeout context — already effectively compel the same board and shareholder approvals required of mergers by statute because of the availability of protective shareholder rights plans (“poison pills”). See Subramanian, supra note 37, at 49 (“[In practice, the poison pill makes board approval a prerequisite even for tender offers. And on the second step . . . approval from a majority of shares outstanding (in the form of shares tendered) [is required] . . . ”) (footnote omitted). As a consequence, three types of transactions — arm’s-length mergers, freezeout mergers, and arm’s-length tender offers — tended to force a certain type of valuation, one tied to intrinsic value rather than pegged to market price; meanwhile, in a fourth type of transaction, freezeout tender offers, the “sole . . . constraint” on controllers was the (manipulable) “prevailing market price.” id. at 31.

45 See Subramanian, supra note 37, 48–64 (proposing a “doctrinal recalibration,” id. at 48, to mimic arm’s-length transactions).


47 A combination of negotiations by independent board members and the “shadow of entire fairness review,” Subramanian, supra note 37, at 36, should serve to “detach the offer price from the market price,” id. at 32.

48 See M&F Worldwide, 88 A.3d at 644.
the trend toward replicating arm’s-length transactions in the tender offer context if given the opportunity.

Still, what M & F Worldwide clarified with respect to doctrine and policy it may have muddied with respect to practice. Recall that the incentive for controllers to employ the dual protections is the availability of dismissal on the pleadings under the business judgment rule. Yet the Delaware Supreme Court suggested that the pleading burden is minimal. In footnote fourteen of the opinion, the court emphasized that the MFW minority shareholders’ complaint “would have survived a motion to dismiss” even under the business judgment standard because it alleged particularized facts suggesting that the merger price was inadequate.49 That allegation in turn “call[ed] into question the adequacy of the Special Committee’s negotiations, thereby necessitating discovery on all of the new prerequisites to the application of the business judgment rule.”50 As commentators have noted, what would have sufficed were “relatively underwhelming non-process and non-conflict related allegations, some variant of which could be made about many, if not most, M&A transactions.”51

If the point seems fairly minor, consider that even before the Delaware Supreme Court opinion, some practitioners expressed doubt that transactional planners would value so highly the opportunity to have lawsuits dismissed on the pleadings that they would be willing to tie their hands by conditioning merger freezeouts ab initio on both special committee and majority-of-the-minority protections.52 The latter are particularly problematic when activist hedge funds threaten to block minority shareholder approval.53 Many controlling shareholders, in other words, might “prefer litigation risk over consummation risk.”54 Footnote fourteen, which seems to increase the litigation risk, will likely dissuade transactional planners at the margin from employing the dual-protection structure. Controllers who wish to freeze out minority shareholders may simply forego the opportunity for business judgment review and price the cost of settling the inevitable litigation into their

49 Id. at 645 n.14.  
50 Id.  
53 See Suneela Jain et al., Examining Data Points in Minority Buy-Outs: A Practitioners’ Report, 36 DEL. J. CORP. L. 939, 950 (2011) (“THere exist real risks that hedge funds and arbitrageurs will engage in open market purchases of equity sufficient to prevent the satisfaction of a majority of the minority condition.”).  
54 Che Odom, Transaction Lawyers, Take Heed of New Standard When the Deal Involves a Controlling Shareholder, 17 M&A L. REP., no. 14, Apr. 7, 2014, at 513; see also Jain et al., supra note 53, at 955.
offers. Others may still opt to use the protections, despite the difficulty of dismissal on the pleadings, in order to increase the likelihood of a grant of summary judgment in their favor, but only if the cost of settling is likely to be higher than the cost of extensive discovery. Practitioners, in other words, may not accept M&F Worldwide’s invitation as readily as the court would like.

M&F Worldwide provided long-awaited answers with respect to the doctrine and policy of freezeout transactions in Delaware. The message to practitioners seems clear: the court would prefer to stay within its area of expertise and ensure fairness by policing the mechanics of the freezeout process rather than by engaging in independent valuation of transactions, so long as transactional planners adhere scrupulously to the arm’s-length-mimicking process the court endorsed. Nonetheless, the case also raised important empirical questions about how practitioners will respond. It is too early to predict definitively whether the possibility of dismissal on the pleadings will induce many controllers to offer shareholders the dual protections of special committee and majority-of-the-minority approval. Footnote fourteen seems to make dismissal on the pleadings fairly unlikely, but a recent Chancery Court opinion invoked M&F Worldwide to dismiss a challenge to a merger freezeout that deliberately followed the transactional structure endorsed in M&F Worldwide, so perhaps practitioners will take heart. Regardless, M&F Worldwide took a significant step toward remedying the incoherence of Delaware’s freezeout doctrine and policy by tying protections and standards of review to prevailing norms of arm’s-length transactions.

55 See Jain et al., supra note 53, at 950–55.

56 See Transcript of Oral Argument on Defendants’ Motion to Dismiss and the Court’s Ruling, Swomley v. Schlecht, No. 9355-VCL (Del. Ch. Aug. 27, 2014), 2014 WL 4470947. But see Yaron Nili, Delaware in 2014: Increasing Deference to Directors’ Decision, HARY. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 3, 2015, 9:02 AM), http://blogs.law.harvard.edu/corpgov/2015/02/03/delaware-in-2014-increasing-deference-to-directors-decision [http://perma.cc/6B54-LTV5] (arguing that Swomley did not actually follow the approach indicated in footnote fourteen, but rather dismissed the case at the pleading stage “notwithstanding that the plaintiffs’ objections to the price, process, and disclosure relating to the transaction appeared to be more specific and compelling than the pleadings in M&F Worldwide that the Supreme Court had indicated in the footnote would have survived dismissal”). Interestingly, a New York court, applying New York law, also recently adopted M&F Worldwide’s rationale to dismiss a similar merger freezeout challenge on the pleadings. See In re Kenneth Cole Prods., Inc., S’holder Derivative Litig., 122 A.D.3d 500 (N.Y. App. Div. 2014).