CHOOSING THE APPROPRIATE STANDARD OF REVIEW WITH MERGERS BETWEEN A CONTROLLING STOCKHOLDER AND ITS SUBSIDIARY: THE BUSINESS JUDGMENT RULE V. ENTIRE FAIRNESS STANDARD

By Dorian Thomas Hicks*

Kahn v. M&F Worldwide Corp., 88 A.3d 635 (Del. 2014).

In *Kahn v. M & F Worldwide Corp*, the Supreme Court of Delaware affirmed the Court of Chancery's summary judgment in favor of the defendants in a dispute that arose from a 2011 going-private merger between MacAndrews & Forbes Holdings, Inc. ("M & F") and M & F Worldwide Corp. ("MFW").[1] M & F was a 43% stockholder in MFW when it proposed to purchase the remaining common stock of MFW.[2] Plaintiffs alleged breaches of fiduciary duty in the form of self-dealing.[3] The traditional standard of review to be applied when a plaintiff alleges self-dealing by a controlling shareholder is the "entire fairness" standard, where the defendant bears the burden to persuade the court that the transaction is entirely fair to the minority stockholders.[4] The Court of Chancery concluded that the "business judgment" standard of review in which the Plaintiff bears the burden of persuasion should apply rather than the "entire fairness" standard if, but only if:

the controller conditions the transaction on the approval of both a Special Committee and a majority of the minority stockholders;

(ii) the Special Committee is independent;

(ii) the Special Committee is empowered to freely select its own advisors and to say no definitively;

(iv) the Special Committee acts with care;

(v) the minority vote is informed; and

(vi) there is no coercion of the minority.[5]

The Court of Chancery concluded that the defendants met these conditions and the business judgment standard was appropriate.[6] Furthermore, the court found that the plaintiffs failed to raise any genuine issues of material fact that would preclude summary judgment.[7]

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[1] Kahn v. M & F Worldwide Corp. (*Kahn*), 88 A.3d 635, 638 (Del. 2014).

[2] *Id.*

[3] *Id.*

[4] *Id.* at 642.

[5] *Id.* at 639.

[6] *Id.*

[7] *Id.*

In *Kahn v. Lynch Communication Systems, Inc.*,[8] the Supreme Court of Delaware had held that the defendants may shift the burden of persuasion to the plaintiff under the "entire fairness" standard by showing that either the transaction was approved by a Special Committee of independent Directors or the transaction was approved by an informed and uncoerced vote of the majority of the minority shareholders. In *Kahn v. M & F Worldwide Corp.,* the Court of Chancery was called upon to decide a matter of first impression regarding which standard of review to be applied when a merger between a controlling stockholder and its subsidiary is conditioned *ab initio* on approval of both a Special Committee of independent Directors and an informed and uncoerced vote of the majority of minority stockholders.[9]

MFW is a holding company in Delaware that was 43.4% owned by M & F.[10] M & F was entirely owned by Ronald O. Perelman.[11] The board of MFW consisted of thirteen Directors—three of those Directors were officers of both MFW and M & F.[12] Ronald Perelman was the chairman of MFW and the Chairman and CEO of M & F.[13] Barry Schwartz was the President and CEO of MFW and the Vice Chairman and Chief Administrative Officer of M & F.[14] William Bevins served as the Vice President of M & F.[15]

On June 13, 2011, Schwartz sent a letter to the MFW board on behalf of M & F proposing to buy the remaining shares of MFW.[16] M & F's proposal included two procedural conditions to protect stockholder interests.[17] The first condition was that the merger be negotiated and approved by an independent Special Committee of MFW Directors.[18] The non-waivable second condition was that the merger be approved by a majority of the minority stockholder vote.[19] The proposal further stated that M & F had engaged independent financial and legal advisors, and that M & F would "encourage the Special Committee to retain its own legal and financial advisors to assist it in its review."[20] M & F filed the proposal letter with the Securities and Exchange Commission and issued a press release disclosing substantially the contents of the proposal.[21]

On June 14, 2011, the MFW board met to consider the proposal.[22] After Schwartz presented the proposal to the board on behalf of M & F, he and Bevins recused themselves from the

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8 Kahn v. Lynch Commc'n Sys., 638 A.2d 1110, 1117 (Del.1994).

9 *Kahn*, 88 A.3d at 638.

10 *Id.* at 640.

11 *Id.*

12 *Id.*

13 *Id.*

14 *Id.*

15 Kahn v. M & F Worldwide Corp. (*Kahn*), 88 A.3d 635, 640 (Del. 2014).

16 *Id.*

17 *Id.*

18 *Id.*

19 *Id.*

20 *Kahn*, 88 A.3d at 641.

21 *Id.*

22 *Id.*

meeting because they both held positions on the board of M & F.[23] The remaining independent Directors invited independent legal counsel to join the meeting.[24] The MFW Directors resolved to form the Special Committee and determined further that "[t]he Special Committee is empowered to make necessary investigations of the Proposal, evaluate the terms of the Proposal, negotiate the terms of the Proposal, report recommendations to the Board of Directors, and to elect not to pursue the Proposal. The Special Committee was empowered to retain independent legal counsel and financial advisors in connection with the transaction.[25] After the merger was approved by the Special Committee and a vote of 65.4% of MFW's minority stockholders, excluding M & F and its affiliates, the merger closed in December of 2011.[26] The Plaintiffs then brought the original action against the defendants for breach of fiduciary duty.[27]

The Court of Chancery held that "rather than entire fairness, the business judgment standard of review should apply 'if, *but only if*:[28] (i) the controller conditions 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 acts with care; (v) the minority vote is informed; and (vi) there is no coercion of the minority.'"[29] The Court of Chancery concluded that the prerequisites for the usage of the business judgment standard of review, rather than entire fairness, were satisfied and the appellants "failed to raise any genuine issue of material fact indicating the contrary."[30] The Court granted summary judgment for the defendants after reviewing the Merger using the business judgment standard of review.[31]

On appeal the appellants challenged the Court of Chancery's summary judgment for two reasons.[32] First, the appellants claimed that the Directors included in the Special Committee were unable to discharge their duties impartially due to their lack of independence and intimidation from other Directors. [33] Second, they claimed that the majority of the minority votes were unduly influenced by experienced investors who were partial to approving transactions that offer market premiums because of the potential risk free profits associated with price inefficiencies.[34] The appellants also contended that even if both procedural protections were adopted, the "entire fairness standard should be retained as the applicable standard of review."[35] The Appellees argued that the business judgment standard of review should be used because when both procedural protections were used and established pretrial, the going private merger became analogous to a "third-party arm's length merger under Section 251 of the Delaware

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[23] *Id.*

[24] *Id.*

[25] *Kahn*, 88 A.3d at 641.

[26] *Id.* at 638.

[27] *Id.*

[28] Italicized by Court of Chancery, per *Kahn,* 88 A.3d at 639, n.2

[29] *Id.* at 639.

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] Kahn v. M & F Worldwide Corp. (*Kahn*), 88 A.3d 635, 639 (Del. 2014).

[35] *Kahn*, 88 A.3d at 639, 643.

General Corporation Law."[36]

The Supreme Court of Delaware affirmed the Court of Chancery's summary judgment and agreed with the decision of The Court of Chancery in every part of its analysis. First, the Court articulated the circumstances that enable a controlled merger to be reviewed under the business judgment standard rather than the entire fairness standard.[37] Then the Court addressed whether those circumstances had been "established as a matter of undisputed fact and law in this case."[38]

In order for the combination of Special Committee and majority of the minority stockholder approval to qualify jointly for business judgment review rather than entire fairness review, each procedural protection must be effective on its own to warrant a shift from entire fairness to business judgment.[39] The Supreme Court of Delaware began the analysis of the two protections by discussing the independence, mandate, and process of the Special Committee.[40] Next, the Supreme Court of Delaware analyzed the majority of the minority vote.[41]

The appellants specifically challenged the independence of three Special Committee members; Webb, Dihn, and Byorum.[42] The appellants questioned the impartiality of these Special Committee members because of their prior business or social dealings with Perelmen.[43] In order to show that a Director is not independent, a plaintiff must show that the controlling shareholder influenced the Director to such an extent that the Director's discretion was be sterilized.[44] In order to show such influence, the Plaintiff must meet a materiality standard which requires a conclusion from the Court that the "Director in question had ties to the person whose proposal or actions he or she is evaluating that are sufficiently substantial that he or she could not objectively discharge his or her fiduciary duties."[45] The Supreme Court of Delaware concluded that mere allegations of social relationships or prior business dealings between two individual does not meet the materiality standard unless it is shown that those ties were material "in the sense that the alleged ties could have affected the impartiality of the individual Director."[46]

With regard to the appellant's challenge to the majority of the minority vote, the Supreme Court of Delaware agreed with the Court of Chancery's conclusion that the Appellants failed to dispute the fact that the majority of the minority stockholder vote was fully informed and uncoerced because the Appellees made all proper disclosures and the Appellants failed to produce any evidence to the contrary.[47] On appeal, the appellants failed again to produce

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[36] *Id.* at 639.

[37] *Id.* at 646.

[38] *Id.*

[39] *Id.*

[40] *Id.*

[41] *Id.* at 646-47, 653-54.

[42] *Id.* at 647.

[43] *Id.*

[44] *Id.* at 648-49.

[45] *Id.* at 649.

[46] *Kahn,* at 649.

[47] *Id.* at 654.

evidence to the contrary.[48] The Supreme Court of Delaware affirmed the Court of Chancery's summary judgment and held that the "business judgment rule standard of review applies to this controlling stockholder buyout"[49]

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[48] *Id.*

[49] *Id.*