Fighting Lawsuits In A Controller Buyout

by Andrew W. Stern, Alex J. Kaplan, and David L. Breau

When a "controlling" shareholder seeks a buyout of the rest of the company's stock, be assured that class action suits by minority holders will follow. However, a new Delaware Supreme Court ruling suggests that smart structuring of the deal (and an effective role for the board) may lead to dismissal of strike suits early in the game.

As surely as night follows day, a merger announcement triggers a swarm of lawyer-driven class action lawsuits, sometimes filed within hours of the announcement. At best, these suits distract directors and senior executives from the task at hand—closing the deal—or add to acquisition costs. At worst, litigation threatens to derail the deal altogether or drags on for years, as legal costs spiral ever higher.

The Delaware Supreme Court's decision earlier this year in *Kahn v. M&F Worldwide Corp.* offers a roadmap to help directors navigate or even avoid altogether, the thicket of shareholder litigation in a "controller" buyout. This article offers some practical observations and tips for directors and other deal participants to help chart that course.

In suits challenging an arm's-length merger, defendants enjoy the benefit of the "business judgment" standard. Courts will defer to directors' business judgment as long as the merger was approved by a disinterested, independent board or special committee and a vote of fully-informed shareholders. This deference means that defendants can win dismissal of such suits at the pleading stage, before potentially costly document discovery and time-consuming depositions.

By contrast, until the *M&F Worldwide* decision, a lawsuit challenging a controller buyout always triggered a so-called "entire fairness" review. This required the Delaware Chancery Court (the trial court where Delaware shareholder litigation is filed) to conduct a fact-intensive review to ensure that the transaction was entirely fair to minority shareholders, in terms of both process and price.

Price is self-explanatory. "Process" refers to how a transaction was initiated, structured, negotiated, and disclosed to directors, and how approvals of directors and shareholders were obtained.

Because courts typically cannot conduct this review without a complete evidentiary record, including depositions of key players, it had been virtually impossible for defendants to win dismissal of even the flimsiest of lawsuits before the long and costly slog through discovery. Moreover, even after discovery, it was difficult to obtain dismissal before trial unless discovery yielded no genuine factual disputes regarding fairness of price or process. In requiring entire fairness review in controller buyouts, courts presumed that a controller's influence always undermined the protections available to minority shareholders, even if robust safeguards were built in.

***M&F Worldwide* acknowledges that you can structure controller buyouts to counteract controller influence over negotiating the terms of the deal.**

Much of this landscape changed when the highly influential Delaware Supreme Court ruled that the business judgment standard may apply to controller buyouts under conditions that replicate the protections afforded to shareholders in an arm's-length merger. This deferential standard now will govern controller buyouts of Delaware companies where the controller conditions the transaction at the outset on approval by both an independent and disinterested

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special committee *and* a majority of the minority shareholders.

This shift acknowledges what directors and other dealmakers have known for a long time—that it is possible to structure controller buyouts in a way that effectively counteracts any influence the controller might have over the target's ability to negotiate the terms of the deal.

Controller buyouts rarely have used both of these features together. Controllers had no incentive under the law to cede power to independent directors and minority shareholders, given that an "entire fairness" review was unavoidable. The Delaware Supreme Court's shift was motivated by its belief (supported by scholarly research and empirical data) that controller buyouts with both of these features provide the best protection to minority shareholders.

The Delaware decision may now make it possible for defendants to win dismissal of shareholder suits at the pleading stage, before costly discovery.

Courts traditionally subjected controller buyouts to an "entire fairness" review because the controller stands on both sides of the transaction. This increases the risk that minority shareholders' interests might be ignored. However, when a buyout is structured so that the controller cannot influence the decisions of either independent directors or minority shareholders, the buyout replicates an arm's-length merger.

The Court's endorsement of this standard for controller buyouts may now make it possible for defendants to win dismissal of shareholder suits at the pleading stage, before costly discovery. However, the jury is still out on whether this possibility is more than merely theoretical. In the *M&F Worldwide* decision, the court's dismissal of the lawsuit occurred much later, at the summary judgment phase, after discovery but before trial.

To be sure, dismissal after discovery but before trial is a significant benefit to defendants as well. A trial is costly and entails considerable risk. Although the defendants in *M&F Worldwide* avoided the expense and risk of a trial, they already had endured extensive, and no doubt expensive, discovery. Indeed, the Court expressly based its decision to dismiss the case on evidence that came to light during discovery.

At least one court has dismissed a shareholder suit challenging a controller buyout before extensive discovery was conducted. In a New York class action lawsuit filed in the wake of Kenneth Cole's proposal in February 2012 to take his eponymous footwear and apparel company private, the trial court dismissed the case at the pleading stage. Cole was the company's controlling shareholder, and conditioned his proposal on approval by both a special committee of independent directors and a majority of the company's shareholders unaffiliated with him. The trial court concluded that the business judgment rule applied and dismissed the case.

The plaintiffs' bar is undoubtedly already hard at work seeking ways to navigate around the *M&F Worldwide* decision. In many shareholder suits, the plaintiffs' main goal is simply to inflict enough pain on the defendants to motivate them to settle rather than continuing the fight, even if the defendants are likely to prevail at trial.

Plaintiffs file their lawsuits hoping to clear the first hurdle by defeating the defendants' motion to dismiss. Doing so enables plaintiffs to proceed to full-blown discovery, which they know may be the club they need to extract a larger settlement. Although the plaintiffs' allegations in the *M&F Worldwide* case were sufficient to clear this first hurdle, the Delaware Supreme Court's decision could chart a path for controllers and directors in future lawsuits to win early dismissal.

A number of issues may still make it difficult in practice for defendants to win early dismissals of lawsuits challenging controller buyouts. While the Delaware Supreme Court opened a door with its decision in *M&F Worldwide,* it is not yet clear whether courts in future cases will walk through it. Nevertheless, the opinion suggests several steps that can increase the odds of winning shareholder suits before they proceed too far out of the gate.

☐ ***First, the controller should condition the proposed transaction at the outset on approval by both***

the independent special committee and a majority of the minority shareholders. The Delaware Supreme Court's decision makes clear that controllers must clearly establish these conditions up-front in order to get the benefit of the business judgment standard. By doing so, the controlling shareholder is held to its commitment to neither bypass the special committee, nor make a ninth-inning offer of a majority-of-the-minority vote to avoid increasing its opening price.

The controlling shareholder's proposal in *M&F Worldwide* provides a template for the unequivocal approach that controllers should take. The controller's proposal stated: "It is our expectation that the board of directors will appoint a special committee of independent directors to consider our proposal and make a recommendation to the board of directors. We will not move forward with the transaction unless it is approved by such a special committee. In addition, the transaction will be subject to a non-waivable condition requiring the approval of a majority of the shares of the company not owned by" the controlling shareholder or its affiliates.

The Delaware Supreme Court endorsed this unequivocal approach, reasoning that, "where the controller irrevocably and publicly disables itself from using its control to dictate the outcome of the negotiations and the shareholder vote, the controlled merger then acquires the shareholder-protective characteristics of third-party, arm's-length mergers."

It must be clear that the controlling shareholder did not dictate the terms of the transaction and the committee exercised real bargaining power at an arm's length.

☐ ***Second, the special committee must be scrupulously independent and disinterested, not merely a perfunctory committee of outside directors that can be seen as beholden to the controller.*** The committee must of course be free to select its own financial and legal advisors, so that it can conduct its own independent analysis. Delaware courts will focus on the special committee's independence in considering whether full-blown discovery is necessary. If the court finds credible the plaintiffs' allegations that the committee lacks independence, it will not dismiss the case before permitting the plaintiffs to conduct discovery to uncover evidence relevant to such allegations.

The special committee should not only be independent on paper; it also must act that way. Throughout the entire process, it must be clear the controlling shareholder did not dictate the terms of the transaction, and that the committee exercised real bargaining power at an arm's length. This includes the ability to determine whether another transaction (or no transaction at all) is better for the minority shareholders than that being offered by the controller.

Although the special committee must be able to effectively negotiate all terms of a deal, one term is most important—price. The crux of this standard is whether the committee bargained with the controller for the best price, and could have said no if it concluded that the deal was not in the best interest of minority shareholders.

The Court in *M&F Worldwide* noted a number of reasons why the plaintiffs' complaint could not have been dismissed before discovery. All of these were different facets of the same issue—the plaintiffs alleged that the price offered by the controlling shareholder was too low. In support of that claim, the plaintiffs had pointed to such measures as profits per share, prices in similar transaction, trading prices, and commentators' opinions of the offer price.

In the Delaware Supreme Court's view, the plaintiffs had credibly alleged—assuming the truth of the allegations, which the court must do when addressing a threshold motion to dismiss—that the price was inadequate. This called into question the committee's negotiations on price and, therefore, necessitated discovery to uncover pertinent facts.

The Court's opinion explains that holding out the carrot of allowing the business judgment standard in controller buyouts will encourage controllers and directors to better protect minority shareholders. The opinion, however, suggests that it may be difficult in practice to demonstrate in the early stages of litigation that the special committee was effective in negotiating the price.

One challenge to winning early dismissal of a lawsuit is that the Delaware Chancery Court cannot review or consider any evidence at the pleading stage of the case. Thus, even if the defendants could marshal evidence at the outset that would disprove the plaintiffs' claims, the court may not consider such evidence in deciding whether to grant a motion to dismiss. As long as the plaintiffs' allegations are plausible, the case will not be dismissed and will proceed to full-blown discovery.

Evidence should persuade the court that the board special committee effectively negotiated with the controlling shareholder.

According to the Court in *M&F Worldwide,* determining whether an independent committee was effective in negotiating a price is "so fact-intensive and inextricably intertwined with" the question of whether the price is fair that it is "often impossible" to make this determination without conducting a trial. The implication may be that, in the Delaware Supreme Court's view, courts should not attempt to determine whether a special committee effectively negotiated a price until the factual record has been developed through discovery.

Nevertheless, it is incumbent upon independent directors to exercise their fiduciary duties by negotiating the highest price possible on behalf of the minority shareholders. Even if litigation proceeds to full-blown discovery, the evidence eventually should persuade the court that the special committee effectively negotiated with the controlling shareholder.

The Delaware Supreme Court's holding suggests that situations will arise where a special committee's negotiations were so plainly effective that a court will reach that conclusion before discovery. Even if full discovery cannot be avoided, the possibility of winning summary judgment before trial is far more attractive than facing the prospect of proving to the court at trial that the special committee's deal was entirely fair to the minority shareholders. Better yet, if such negotiations are fully disclosed in the proxy, there may come a day when plaintiffs' lawyers refrain from reflexively filing class action lawsuits on every such transaction.

☐ ***Third, the vote of the minority shareholders must be fully informed.*** The decision in *M&F Worldwide* notes that the proxy supplied to investors provided the history of the special committee's work and negotiations with the controlling shareholder. It detailed, among other things, the committee's consideration of multiple price ranges and underlying valuation analyses prepared by the committee's financial advisor.

However, the Court did not engage in an in-depth analysis of the disclosures in the proxy because the plaintiffs themselves did not dispute that the shareholder vote was fully informed. Indeed, the plaintiffs did not allege any insufficiency in the proxy disclosures. This is quite notable and should serve as one of the goals of drafters of proxy statements when deciding what to disclose. Success is achieved when even enterprising plaintiffs' lawyers picking through the proxy with a fine-toothed comb cannot find a single piece of information that they can plausibly argue should have been disclosed.

A controlling shareholder should refrain from any action that could be considered coercive, such as threatening to block other transactions, or to make a lower-priced tender offer if the buyout is voted down.

Given the Delaware Supreme Court's decision, the proxy should disclose in complete detail any information that relates to price negotiations. These disclosures should include any information that the special committee considered in conducting those negotiations, such as financial analyses prepared by its financial advisors, along with any assumptions used to prepare them.

In addition, the proxy should disclose prior business dealings or other relationships that committee members may have had with the controlling shareholder, even if such relationships do not give rise to a conflict. Likewise, any potential conflicts, including prior engagements of the committee's financial or

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What (And What Not) To Do

Controlling Shareholder	Independent Directors
Do	**Do**
• State in your proposal that you expect the board to appoint a special committee of independent directors to consider your proposal.	• Ensure that the resolution creating the special committee expressly grants it the power to say "no" to the controlling shareholder.
• State in your proposal that you will not proceed with the buyout without the special committee's approval *and* a non-waivable majority of minority vote.	• Retain independent financial and legal advisors.
• State that a rejection of your proposal will not adversely affect your future relationship with the company.	• Ensure your advisors are conflict-free by carefully scrutinizing their prior dealings with the company and the controller.
• Disclose *everything* in the proxy.	• Ensure that your advisors provide you with a thorough analysis of the company and its business, comparable companies and transactions, and economic conditions in order to strengthen your hand in negotiations with the controller.
	• Keep detailed minutes and attendance of all committee meetings and all interactions with the company and the controller.
	• Disclose *everything* in the proxy.
Don't	**Don't**
• Don't threaten to take other action that may be contrary to the best interests of the company (although you can refuse to sell your own shares).	• Don't accept recommendations on choice of financial or legal advisors from the controlling shareholder.
• Don't threaten a tender offer if your proposal is rejected.	• Don't rely solely on financial data provided by the controller as the basis for your analyses.
	• Don't avoid aggressive negotiation with the controller even when a competing offer is unlikely.

legal advisors by the controlling shareholder or the target company, should be disclosed.

☐ ***Fourth, the controlling shareholder and the special committee should refrain from any conduct that could be viewed (or even characterized) as coercive to the minority shareholders.*** The Delaware Supreme Court did not analyze the question of coercion in its *M&F Worldwide* decision because the plaintiffs did not allege that any such conduct had occurred. Nonetheless, a controlling shareholder should refrain from any action that could be considered coercive. This includes, for example, threatening to block other transactions that may be in the best interest of the company or to make a lower-priced tender offer if the buyout is voted down.

The approach of the controlling shareholder in *M&F Worldwide* is instructive. The controlling shareholder's proposal stated, "If the special committee

does not recommend or the public stockholders of the company do not approve the proposed transaction, such determination would not adversely affect our future relationship with the company and we would intend to remain as a long-term stockholder."

Of course, nothing requires a controlling shareholder to take any actions that are contrary to its own interests as shareholder. Thus, courts have generally found no problem with a controlling shareholder that makes clear that it has no intention to sell its own shares to a third party—even at a higher price.

The controlling shareholder's proposal in *M&F Worldwide* was clear in this regard: "In considering this proposal, you should know that in our capacity as a stockholder of the company we are interested only in acquiring the shares of the company not already owned by us and that in such capacity we have no interest in selling any of the shares owned by us in the company nor would we expect, in our capacity as a stockholder, to vote in favor of any alternative sale, merger or similar transaction involving the company."

Plaintiffs may argue that a controlling shareholder's refusal to participate in alternative transactions hamstrings the special committee's ability to negotiate effectively with the controller. However, courts typically do not require a controlling shareholder to undermine its own interests as a shareholder simply to benefit the minority shareholders. In other words, proposals like this probably will not be considered coercive.

The Delaware Supreme Court's decision in *M&F Worldwide* was highly anticipated and greeted with much fanfare in the legal press. Nevertheless, it remains to be seen whether defendants are in fact able to win dismissals of shareholder suits challenging controller buyouts before costly discovery is conducted. If "good behavior" by controlling shareholders and independent directors is not rewarded, then controllers may decide that such protections are not worth the trouble.

Even if discovery remains largely unavoidable, the possibility of obtaining dismissal before trial is an ample benefit. Controllers and directors should not lightly disregard it in deciding whether to structure a buyout with these minority shareholder protections.

There is one final point worth noting. One of the Chancery Court's most vocal proponents of the change was former Chancellor Leo E. Strine, Jr., who authored several of the Chancery Court's decisions on this issue (including the *M&F Worldwide* decision that the Supreme Court affirmed). The former Chancellor no longer serves on the Chancery Court because, on January 29, 2014, he was confirmed as the new chief justice of the Delaware Supreme Court. ■

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