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ALERT MEMORANDUM

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Controlling Stockholder "Going Private" Transactions after *In Re MFW*: Reasons to Be Wary of the Path to the Business Judgment Rule

Chancellor Leo Strine's opinion in *In re MFW Shareholders Litigation (Del Ch. May 29, 2013)* marks the culmination of an effort by the Chancellor, going back to his lengthy dicta in *In re Cox Communications Shareholders Litigation (Del Ch. 2005)*, to arrive at a more unified standard for review of buy-outs of a company's public float by a controlling stockholder. The headline conclusion is that, assuming this decision is not reversed by the Delaware Supreme Court on appeal, controlling stockholder buyouts structured as negotiated mergers may now join controlling stockholder buyouts that take the form of unilateral tender offers in having available a theoretical path that permits challenges to be dismissed on pre-trial motions.

About ten years ago, a series of Chancery Court opinions, the most prominent of which was then-Vice Chancellor Strine's opinion in *In re Pure Resources Shareholders Litigation (Del. Ch. 2002)*, laid out safeguards that would qualify a unilateral tender offer by a controlling stockholder as non-coercive and entitled to dismissal of challenges based on pleadings prior to a trial or an evidentiary hearing. The most important of these safeguards were the presence of both:

- the existence of an independent special committee process at the target board;

  and

- the unwaivable conditioning of the tender offer on acceptance by a majority of the shares held by the "minority" (i.e., those holders unaffiliated with the controlling stockholder or the target; of course, these "minority" holders may in some instances constitute a majority if the controlling stockholder and its affiliates own less than 50% of the voting power).

MFW lays out a path, similar to that spelled out in *Pure Resources*, for controlling stockholder buyouts to follow in the context of negotiated mergers. The Court held that, notwithstanding prior precedents that had been read by many practitioners and academics to the contrary, a merger agreement for a controlling stockholder buyout will be subject to deferential business judgment review when the transaction arises from an offer by the controlling stockholder that, from the outset, commits both to proceed only on terms negotiated with and approved by an independent special committee *and* to inclusion in the merger agreement of an unwaivable condition that approval by a majority of the shares held by the "minority" shall have been obtained. Before *MFW*, the only pathway to dismissal pre-trial of challenges to a controlling stockholder buyout was for the parties to follow the *Pure Resources* route of a unilateral tender offer. If, instead, the transaction included the execution of a merger agreement, the transaction would always be subject to heightened "entire fairness" review.

Although the presence of procedural safeguards (including special committee approval *or* a majority-of-the-minority condition) could be sufficient to shift the burden to the plaintiffs in stockholder suits, dismissal pre-trial was virtually impossible in the face of the strict standards of entire fairness. In a recent article, cited approvingly in *MFW*, some of us surveyed controlling stockholder buyout transactions from 2006 to 2010 to assess the impact that this pre- *MFW,* state of the case law was having on deal structuring. We found that 70% of the controlling stockholder transactions chose to negotiate a merger agreement with a special committee of independent directors rather than follow the *Pure Resources* tender offer route, even though this approach made the deal subject to "entire fairness" review. Why were most controlling stockholders going out of their way to avoid the *Pure Resources* route and embrace an approach that would be subject to a more stringent standard of review? One of the article's conclusions was that, from the perspective of controlling stockholders, the execution risks that arise from a majority-of-the-minority condition (which condition *must* be included in a unilateral tender offer under the *Pure Resources* approach) – especially in a market that is increasingly dominated by hedge funds and institutional investors willing to follow their leads in threatening to block stockholder approvals – often outweighs the benefits of having an opportunity to win on a pre-trial motion in Chancery Court. Another of the article's conclusions, based on review of the data about these four years of controlling stockholder transactions, was that the rate of litigation and, more importantly, the costs of settling "entire fairness" challenges to controlling stockholder buyouts structured as negotiated mergers without majority-of-the-minority conditions (less than half the negotiated mergers had such conditions) were not meaningfully different than the litigation rate and settlement costs for controlling stockholder buyouts structured as unilateral tender offers that appeared to satisfy the *Pure Resources* criteria. Moreover, not a single one of the litigation challenges to unilateral tender offers that appeared to satisfy the *Pure Resources* criteria was dismissed on the pleadings – i.e., the controlling stockholder defendants in these unilateral tender offers (with majority-of-the-minority conditions) found settlement to be a more attractive option even when deferential review should have been available and then they appeared to end up settling on terms not meaningfully more burdensome than if they had taken the "entire fairness" route of negotiated mergers with special committees, but without majority-of-the-minority conditions.

The Chancellor now suggests in *MFW* that controlling stockholders are more likely to start embracing unwaivable majority-of-the-minority conditions in negotiated mergers if, as a result, the presumption of the business judgment rule will be available. But there is a good chance that some controlling stockholders will prefer to take their chances on "entire fairness" review of a buyout negotiated with a special committee (and without a majority-of-the-minority condition), rather than embracing the carrot of the business judgment rule offered in *MFW*, for the following reasons:

- *Costs of extensive discovery will still apply*. Even if the approach outlined in *MFW* is followed closely, dismissal before extensive discovery is unlikely to be available. This decision and others lay out roadmaps for plaintiffs to follow to insulate their complaints from being tossed on a motion to dismiss before extensive discovery. Allegations that challenge the independence of the directors on the special committee, the adequacy of the disclosure in the proxy statement, the fulfillment of the duty of care by the committee members, and the

criteria for determining which stockholders belong in the "minority" for purposes of the majority-of-the-minority condition, are all likely to be fair game for insulating a complaint in this context from dismissal before discovery.

- *Costs/Risks of majority-of-the-minority may be high.* As the Court in *MFW* notes and experienced advisors are well-aware, the execution risks that arise from subjecting the buyout to an unwaivable majority-of-the-minority condition are potentially high.

- *Settlement of entire fairness claims may be feasible without significant cost above the cost of settling business judgment rule claims*. As Chancellor Strine alludes in *MFW* and as the data in the article referenced above shows, plaintiffs and their counsel are often quick to settle even if they have the entire fairness standard on their side, especially if there appears to have been an effective special committee process or a bump in the price (as there inevitably is) following the initial proposal by the controlling stockholder.

- *Victory at trial on entire fairness claims is achievable where an effective special committee handled negotiation of the merger agreement*. For those controlling stockholders and target directors with the fortitude to go to trial to defend against entire fairness claims, there are precedents for victory by the defendants even in the absence of unwaivable majority-of-the-minority conditions. See, e.g., the post-trial decisions by then-Vice Chancellor Strine in *In re Cysive,Inc. Shareholders Litigation (Del. Ch. 2003)* and by former Chancellor William Chandler in *In re John Q. Hammons Hotels, Inc. Shareholders Litigation (Del Ch. 2011)*, both transactions involving controlling stockholders (*Cysive* was a buyout of the public float, while *Hammons* involved a sale of the company where the controlling stockholder received differential consideration) where the entire fairness claims failed after trial even in the absence of majority-of-the-minority conditions.

- *The MFW approach requires a "promise" upfront that may limit a controlling stockholder's flexibility for an undefined period.* The *MFW* opinion requires that, as a condition to business judgment rule treatment, the controlling stockholder must make a "promise", in its initial proposal, to the requisite procedural safeguards, including the existence of a majority-of-the-minority condition in a special committee-endorsed merger agreement. On its face, the consequence of this promise would appear to be that the controlling stockholder must simply stand down and abandon its plans for a buyout if either the special committee rejects its proposals or if the majority-of-the-minority stockholder approval cannot be obtained. Accordingly, before controlling stockholders attempt to adhere to

the roadmap for buyout proposals laid out in *MFW*, they ought to consider the open questions relating to the extent to which this initial "promise" would later be enforceable by the target company or its public stockholders if the controlling stockholder were to elect to deviate from its commitments to these safeguards in consideration of an increase in the offer price; in a switch to a *Pure Resources*-compliant tender offer; or in a new proposal some weeks or months after an impasse in negotiations with the special committee led to a withdrawal of the original proposal.

In connection with these topics, please do not hesitate to reach out to your regular contacts at Cleary Gottlieb or any of the U.S. M&A partners listed and linked below.

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