ALERT MEMORANDUM

Delaware Supreme Court Provides Significant Guidance on Timing Requirement Under *MFW*

October 16, 2018

The Delaware Supreme Court has clarified that controlling stockholder take-private transactions will be reviewed under the business judgment rule, rather than the less deferential entire fairness standard, if the controlling stockholder self-disables by committing to special committee and majority-of-the-minority approval before "economic negotiations" take place, even if the controlling stockholder fails to do so in its initial written offer. *See Flood v. Synutra Int'l, Inc.*, No. 101, 2018 (Del. Oct. 9, 2018).[1]

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors.

NEW YORK

Roger Cooper
+1 212 225 2283
racooper@cgsh.com

Rishi Zutshi
+1 212 225 2085
rzutshi@cgsh.com

One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

The Delaware Supreme Court first announced in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) ("*MFW*") that business judgment review applies to a merger proposed by a controlling stockholder conditioned "*ab initio*" on two procedural protections: (1) the approval of an independent, adequately empowered Special Committee that fulfills its duty of care; and (2) the uncoerced, informed vote of a majority of the minority stockholders.[2] Since then, several Delaware cases have involved questions about whether the *MFW* conditions were in place "*ab initio*."[3] In *Synutra*, the Delaware Supreme Court provided further significant guidance on the meaning of the "*ab initio*" requirement.

[1] Cleary Gottlieb Steen & Hamilton represented Synutra's special committee in obtaining dismissal of Plaintiff's claims in the Delaware Court of Chancery and successfully argued the appeal before the Delaware Supreme Court on behalf of all defendants.

[2] 128 A.3d 992 (Del. 2015) (TABLE).

[3] *See, e.g.*, *Olenik v. Lodzinski*, C.A. No. 2017-0414-JRS (Del. Ch. July 20, 2018); *In re Martha Stewart Living Omnimedia, Inc. S'holder Litig.*, 2017 WL 3568089 (Del. Ch. Aug. 18, 2017); *In re Books-A-Million, Inc. S'holders Litig.*, 2016 WL 5874974, at *1 (Del. Ch. Oct. 10, 2016), *aff'd*, 164 A.3d 56 (Del. 2017); *Swomley v. Schlecht*, C.A. No. 9355-VCL (Aug. 27, 2014) (TRANSCRIPT), *aff'd*, 2015 WL 7302260 (Del. 2015) (TABLE).

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In *Synutra*, the controlling stockholder's initial proposal to take Synutra private did not include the dual *MFW* protections. However, approximately two weeks later, shortly after an independent Special Committee was formed, the controller sent a second letter making clear that the transaction was subject to both approval by the Special Committee and a majority-of-the-minority vote. Critically, this second proposal was received before the Special Committee had engaged its own investment bank or counsel, before any projections were shared, and before any price negotiations took place.

Based on what the court admitted was "ambiguous language" in *MFW*, the plaintiff argued in favor of "the brightest of lines," and contended that a controller "must include the conditions in its 'first offer' or else lose out on the business judgment rule." The Delaware Supreme Court disagreed, explaining that it did not embrace such a "rigid" reading of *MFW*, and elaborating on the more flexible standard that should be applied.

Writing for a majority of the court, Chief Justice Strine explained that "what is critical for the application of the business judgment rule is that the controller accept that no transaction goes forward without special committee and disinterested stockholder approval early in the process and before there has been any economic horse trading." He reasoned that even if those protections were not included in the "first offer," the key concern of *MFW*—"ensuring that controllers could not use the conditions as bargaining chips during economic negotiations"—would still be addressed if the protections were in place before any economic negotiations commenced. The court thus held that "so long as the controller conditions its offer on the key protections at the germination stage of the Special Committee process, when it is selecting its advisors, establishing its method of proceeding, beginning its due diligence, and has not yet commenced substantive economic negotiations with the controller, the purpose of the pre-condition requirement of *MFW* is satisfied." Underlying the court's holding was its recognition that "MFW's dual conditions create 'a potent tool to extract good value for the minority'" and that a flexible approach that incentivizes controlling stockholders to pre-commit to these conditions benefits minority stockholders.

Justice Valihura dissented, arguing that the holding "invites factual inquiries that defeat the purpose of what should be more of a bright line and narrower pathway for pleading-stage dismissals in this context." Although the majority acknowledged that the rule "may give rise to close cases," it concluded that the Court of Chancery is expert in the adjudication of corporate law cases and fully capable of applying the standard appropriately.

The Delaware Supreme Court's important decision in *Synutra* provides further protection for controlling stockholder transactions, even if for whatever reason the controlling stockholder's initial proposal does not explicitly contain the *MFW* conditions. The court cautioned, however, that its holding should not be read as an invitation to wait until a deal is negotiated before making a formal "first offer" with the *MFW* conditions – rather, the touchstone of a court's analysis will be whether there was any "economic horse trading" before the conditions were put in place.

In addition, the Court squarely addressed a question raised by footnote 14 in *MFW*, which suggested that "allegations about the sufficiency of the price call 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." Based on this language, the plaintiff in *Synutra* argued that he could plead a duty of care violation based on allegations that the transaction price was insufficient.

The court rejected plaintiff's argument, characterizing the language in footnote 14 as "dicta that conflicts with the actual due care holding in *MFW*." Although the court noted that this issue arguably had already been resolved by its summary affirmance of *Swomley*, it explicitly clarified that "a plaintiff can plead a duty of care violation only by showing that the Special Committee acted with gross negligence, not by

questioning the sufficiency of the price."[4] The court explained that "the central objective of the *MFW* standard is to provide an incentive for controllers to embrace the procedural approach most favorable to minority investors, with the incentive of obtaining the protection of the business judgment rule standard of review." Any attempts to "inject[] the reviewing court into an examination of whether the Special Committee's good faith efforts were not up to its own sense of business effectiveness" would undermine that key objective.

Finally, the opinion also highlights that potential conflicts of interest continue to attract careful scrutiny from Delaware courts.[5] Here, the controller retained Davis Polk & Wardwell LLP to advise him in the proposed take-private, even though Davis Polk was at the time (and had historically been) Synutra's corporate counsel and provided limited advice to the Synutra board at the meeting that followed the controller's initial offer. Synutra granted Davis Polk a conflict waiver in order to permit the representation, and the Special Committee promptly hired "a highly qualified legal counsel of its choice." The Court of Chancery's opinion suggested that "[i]t would have been preferable, both optically and substantively, for the Buyer Group to retain its own counsel," so that outside counsel for the company could continue its representation and remain in a more neutral position vis-a-vis the Buyer Group and the Special Committee. Nonetheless, the Delaware Supreme Court agreed with the Court of Chancery's ultimate determination that the complaint had not pled facts "supporting an inference that the Special Committee's Counsel was not equipped to represent the Special Committee skillfully and vigorously, nor that it failed to do so." Thus, the court held that the application of the business judgment rule was appropriate in this case.

Takeaways:

— Delaware courts will review a take-private transaction by a controller under the business judgment standard of review when it is conditioned "from the beginning" on the *MFW* protections of approval by both a properly empowered, independent committee and an informed, uncoerced majority-of-the-minority.

— In interpreting what constitutes "the beginning" of a transaction, Delaware courts will conduct a pragmatic analysis of the facts and circumstances of each case, focused on determining when substantive economic negotiations commenced.

— This flexible approach furthers *MFW*'s central objective of encouraging controllers to adopt a process that protects the interests of unaffiliated stockholders by more closely replicating arm's-length negotiations with a third party. As we have written before, although adoption of the *MFW* requirements increases execution risk and limits a controller's flexibility in negotiations, the Delaware Supreme Court continues to counter balance those considerations with the possibility of obtaining business judgment review and dismissal at the pleading stage.

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[4] To kill the zombie language once and for all, the Court stated that "to the extent that note 14 is inconsistent with this decision, *Swomley*, or the Court of Chancery's opinion in *MFW*, it is hereby overruled." *Synutra*, at 23 n.81.

[5] *See, e.g.*, *Haverhill v. Kerley*, C.A. No. 11149-VCL (TRANSCRIPT), at 28:15-29:17 (Del. Ch. Sept. 28, 2017) (noting that "aggressive" conflict calls can raise potential problems on the merits for principals and give rise to potential aiding and abetting exposure for the third parties involved).