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ALERT MEMORANDUM

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Going Private Transactions - MFW's Bumpy Road to Business Judgment Review

On Friday the Delaware Supreme Court affirmed then-Chancellor Strine's grant of summary judgment in the *MFW* case, which set forth a roadmap for a less rigorous standard of review for going private transactions by controlling stockholders. The Supreme Court agreed that if specified steps were taken in such a transaction, the courts would not review the transaction under the stringent "entire fairness" test, but instead would apply the more deferential business judgment rule. However, the Supreme Court's conditions for business judgment review, taken together with the process for establishing these conditions, makes it unlikely that many controlling stockholders will elect to go down this path; even more unlikely than we expected after the Chancellor's opinion last year, as discussed in our June 25, 2013 memorandum (*Controlling Stockholder "Going Private" Transactions after In Re MFW: Reasons to Be Wary of the Path to the Business Judgment Rule*).

In Friday's opinion, the Supreme Court concluded that business judgment review will be available in a going private transaction with a controlling stockholder only if all of the following conditions are satisfied:

- The controlling stockholder conditions the transaction, from the time it makes its initial proposal, on approval of both a special committee and a majority vote of the outstanding shares owned by unaffiliated stockholders (generally referred to as a majority-of-the-minority vote, even if the unaffiliated shares are actually a majority of the outstanding shares);

- The special committee is independent and empowered to select its own advisors and to say no "definitively" and thus veto a proposed transaction;

- The special committee meets its duty of care in negotiating a fair price (a condition that the Court appears to view as involving a combination of both traditional "due care" process considerations and substantive results akin to those necessary to satisfy the "fair price" prong of the entire fairness test); and

- The majority-of-the-minority vote is fully informed and there is no coercion of the minority.

Most significantly, the Supreme Court then noted that the *MFW* complaint itself would have survived a motion to dismiss under these standards because it adequately pleaded that the price of the merger was too low (citing allegations that certain ratios were well below those in similar transactions; that the merger price was lower than the trading price two months earlier; that the share price was depressed at the relevant time due to short-term factors; and that commentators viewed the initial offer and ultimate merger price as surprisingly low). According to the Supreme Court, "These 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" (emphasis added). Furthermore, if a plaintiff "can plead a reasonably conceivable set of facts showing that any or all of those enumerated conditions did not exist" then the case would not be dismissed and the plaintiff can conduct discovery. Then, if after discovery, triable issues of fact remain about whether any of the requirements for business judgment review are satisfied, "the case will proceed to a trial in which the court will conduct an entire fairness review."

Thus, while the Supreme Court's analysis was animated by the apparent view that a controlling stockholder's take-private transaction with the features described above should be treated as an arm's length third party acquisition, the practical result will likely be far different. Assuming the plaintiff can satisfy the seemingly easy pleading burdens of raising some question about the fairness of the price or, for example, raising issues about the independence or engagement of the committee, the case will survive dismissal at the pleading stage. This means the buyer will incur what will likely be substantial discovery costs. Only thereafter will the defendants be able to move for summary judgment (as did the *MFW* defendants). If the Chancery Court concludes at the summary judgment stage that there are no genuine issues of material fact and that the *MFW* standard has been met, then it will apply the business judgment rule, and (given the finding necessary to conclude that the *MFW* standard has been satisfied) almost inevitably dismiss the case. But succeeding on summary judgment will not be easy in this context, where the defendants will have the burden of establishing the absence of issues of fact as to whether the criteria for the applicability of the business judgment rule have been satisfied. Indeed, the Court highlights that the plaintiffs in *MFW* failed to submit any factual or expert affidavits to create issues of fact as to the achievement of a fair price and how ordinarily there are issues of fact for resolution at trial relating to a fair price determination.

Moreover, if defendants can establish satisfaction of all the *MFW* conditions and therefore benefit from the presumption of the business judgment rule at the summary judgment stage or at trial, they would almost certainly have prevailed under entire fairness review even before *MFW*. Furthermore, if the defendants can establish the presence of a well-constituted and functioning special committee that meets its duty of care in negotiating a fair price, as well as the *MFW* conditions on the satisfaction of the duty of disclosure and absence of coercion, then the defendants are likely to prevail under entire fairness even though the controlling stockholder had neither committed at the outset to proceed only with a majority-of-the minority vote condition nor agreed later in the process to such condition.

Will this approach meaningfully change the incentives of controlling shareholders in structuring these transactions and assessing related litigation risks? Despite the good intentions of the Delaware courts to encourage controlling stockholders to utilize an approach that is most favorable to the unaffiliated stockholders, we do not believe that many controlling stockholders considering a going-private transaction will be inclined to follow this blueprint due to the following considerations:

- Plaintiffs will likely be able in most cases to avoid motions to dismiss based on allegations challenging the fairness of the price. In addition, as we noted last year with respect to the Chancery Court decision, in many cases the plaintiff will be able to adequately allege a basis to challenge the independence of members of the

special committee, the quality of the committee's process, and the quality of the proxy statement disclosure. Thus, the controlling stockholder would likely still be subject to the distractions and costs of extensive discovery – a result the Supreme Court found to be appropriate in *MFW* itself. In addition, plaintiffs may similarly be able to defeat motions for summary judgment by producing factual and expert affidavits (which the *MFW* plaintiffs failed to do) on the subject of fair price and thereby drive the case to a costly trial.

- High execution risks are often created by an unwaivable majority-of-the-minority condition, as evidenced by a number of recent transactions and proposed transactions.

- Following the Court's approach is unlikely to reduce the costs of settling most typical stockholder class actions challenging going private transactions, as discussed in our prior memorandum and analyzed based on a data set of five years of going private transactions in an article we published in the *Delaware Journal of Corporate Law*.

- A transaction with a proxy statement meeting the applicable Delaware duty of disclosure, which transaction is subject to entire fairness scrutiny as a result of the presence of a special committee but no majority-of-the-minority vote condition, should withstand plaintiffs' motion to enjoin stockholder approval of the transaction, because there will be an adequate opportunity for a post-closing trial on a damages remedy. Moreover, there are a number of precedents for defendants' winning entire fairness trials after the closing of the transaction if an effective special committee had negotiated the merger, even in the absence of a majority-of-the-minority vote condition.

- The controlling stockholder will sharply limit its flexibility for an unspecified period by making *MFW's* required, upfront commitment to proceed only if the special committee approves the transaction and there is a majority-of-the-minority vote condition.

Accordingly, we expect that controlling stockholders in most contexts will negotiate with a special committee but not commit to (or, often, even subsequently agree to) a majority-of-the-minority condition, and that they will instead retain flexibility. This flexibility will include the possibility, if negotiations are unsuccessful, to switch to a unilateral tender offer conditioned on a majority-of-the-minority tender under the *Pure Resources* line of cases, where a special committee would be empowered to make it's informed recommendation to stockholders, but would not have veto power.

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