Delaware Courts Apply Business Judgment Rule to Controlling Stockholder Transactions

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In the past, the Delaware Chancery Court has typically applied the "entire fairness" standard when evaluating a proposed takeover transaction undertaken by a controlling shareholder. This approach was clearly articulated in *Kahn v. Lynch Communication Systems, Inc.* 638 A.2d 1110 (Del. 1994), wherein the court stated that "the exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness" and that "[t]he initial burden of establishing entire fairness rests upon the party who stands on both sides of the transaction." *Kahn*, 638 A.2d 1110, 1117 (Del. 1994). The entire fairness standard has two components, fair price and fair dealing, each of which must be satisfied independently. It is a burdensome standard that places the obligation on the defendant(s) to show that all aspects of the transaction were ultimately fair to the shareholders.

In two recent cases, the Delaware Supreme Court upheld Chancery Court rulings applying the business judgment rule to evaluate controlling stockholder takeovers. The business judgment rule is a much more favorable standard of review for defendants, requiring that the party bringing the claim show that the defendants did not act in the best interests of the corporation or breached their duty of care or duty of loyalty. It is a much lower standard for defendants to satisfy, and puts the burden of proof on the party bringing the claims.

Kahn v. M&F Worldwide Corp.

In May 2013, former Chancellor Strine, sitting in the Chancery Court, granted summary judgment in favor of defendant MacAndrews & Forbes Holdings Inc., and indicated that the business judgment rule should be applied to evaluate a controlling shareholder transaction *(In re MFW Shareholders Litigation, May 29, 2013)*. In *Kahn v. M&F Worldwide Corp., 2014 WL 996270* (Del. Mar. 14, 2014), the Delaware Supreme Court upheld this ruling and confirmed that a buyout by a controlling shareholder should be reviewed under the business judgment standard, if certain procedural protections were implemented at the outset of the transaction.

MacAndrews & Forbes Holdings, Inc. ("MacAndrews") owned 43% of M&F Worldwide Corp. ("MFW"). In June 2011, MacAndrews offered to take MFW private. MacAndrews' offer contained, among other items, two specific requirements for the transaction:
(1) negotiation and approval by a special committee of independent MFW directors and (2) approval of the acquisition by a majority of the minority stockholders who were unaffiliated with MacAndrews. The MFW board then formed a special committee, and the special committee retained its own separate advisors. The special committee negotiated and approved the transaction terms, and the transaction was then approved by over 65% of the minority stockholders of MFW.

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The plaintiffs brought several claims against both MacAndrews and certain MFW directors, alleging breaches of fiduciary duty and that the transaction was unfair to the minority shareholders, and arguing that the transaction should be evaluated under the entire fairness standard. After considering these claims, the Chancery Court ruled in favor of the defendants and granted summary judgment as to the standard to be applied. The Chancery Court found that the business judgment rule should apply, "if, but only if:

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

2. the Special Committee is independent;
3. the Special Committee is empowered to freely select its own advisors and to say no definitively;
4. the Special Committee acts with care;
5. the minority vote is informed; and
6. there is no coercion of the minority."

With this ruling, the Delaware courts have provided a clear roadmap for controlling stockholders engaging in a takeover transaction. Failure to comply with any of the standards laid out in *Kahn* will likely lead to a review subject to the entire fairness standard, given how explicitly the standard for business judgment review has been stated.

SEPTA v. Volgenau

In *Southern Pennsylvania Transportation Authority ("SEPTA") v. Volgenau, C.A.* No. 461, 2013 (Del. May 13, 2014), the Delaware Supreme Court considered a related question: what standard of review should apply in a merger where there was a controlling stockholder, who was not on both sides of the transaction (as was the case in M&F Worldwide), but who was alleged to have used his position to compete with the minority for merger consideration? In *SEPTA*, the Delaware Supreme Court affirmed a Chancery Court decision holding that a sale of a controlled corporation to an unaffiliated third party would be reviewed under the business judgment standard of review if the transaction is (1) recommended by a disinterested and independent special committee and (2) approved by stockholders pursuant to a non-waivable vote of the majority of all the minority stockholders.

SEPTA involved claims arising from the buy-out of SRA International, Inc. ("SRA") by Providence Equity Partners LLC and its related entities. SRA was a public company with two classes of common stock. Ernst Volgenau, the founder of SRA, controlled SRA through his ownership of Class B shares. Volgenau received the same price per share from the acquirer as the holders of Class A shares, plus some additional consideration such as a small interest in the new entity (issued in exchange for some of his SRA stock) and a consulting agreement with the new entity.

Plaintiffs brought suit, claiming that the controlling stockholder received greater consideration in the merger than did the minority stockholders and that the board breached its fiduciary duties by failing to adhere to the provisions in SRA's charter requiring equal treatment in a transaction for the Class A and Class B stockholders. The Chancery Court ruled, and the Delaware Supreme Court upheld, that the claims should be evaluated under the business judgment rule, and not the entire fairness standard, because the transaction had been approved by a special committee comprised of independent and disinterested directors, and there had been a fully informed, non-waivable vote of a majority of the minority stockholders.

For more information on this topic, please contact a member of our Corporate Practice.