Harmonizing going private transactions

The Delaware Chancery Court gives controlling stockholders a clearer road map for taking a corporation private.

BY DOUG RAYMOND

For the last several years, a stockholder who controlled a Delaware corporation (but did not own all of the stock) has been in a difficult position if he wanted to acquire the remaining shares he did not own. Different standards of legal review potentially applied to a negotiated merger than to a tender offer.

The 2010 case, *In re CNX Gas Corporation Shareholders Litigation*, established that the Delaware courts would apply business judgment rule review in the case of a controlling stockholder tender offer, so long as certain procedural safeguards were in place to protect the minority stockholders.

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Access to this business judgment rule standard for review has made a tender offer followed by a short form merger an appealing structure for going private transactions because when the directors' actions inevitably are challenged in court, the board has a good chance of getting the case dismissed at an early stage of the proceeding.

By contrast, there has been uncertainty whether the more demanding "entire fairness" test enunciated in 1994 in *Kahn v. Lynch* applies to all negotiated mergers with controlling stockholders. Under this factually intensive test, defendants are required to show that the transaction, including both the process used by the board and the price paid, was entirely fair to the minority stockholders. If the defendant had required approval of the merger by *either* a properly functioning special committee or a majority of the noncontrolling stockholders, it would be able to shift the burden of proof to the plaintiff, who would have to prove that the transaction was unfair.

In either case, whether the burden of proof stayed with the defendant or shifted to the plaintiff, this analysis generally involves protracted litigation and concomitant expenses. It has been unclear whether a negotiated merger could ever be eligible for business judgment rule review.

In the recent case *In re MFW Shareholders Litigation,* Chancellor Leo Strine continued his efforts to rationalize the law in this area. In *In re MFW,* a controlling stockholder offered to purchase the remaining equity of the corporation in a going-private merger transaction. Upfront, he conditioned the transaction on approval by *both* an independent special committee and the majority of the minority stockholders, which approvals were subsequently obtained.

The court held that a merger in such a context should be reviewed under the business judgment rule standard, under which the court would defer to the board's determination unless a rational person could not reasonably have reached such a decision. In this context, the court noted that the price constituted a 47% premium above market value and both a financial advisor chosen by the independent special committee and a majority of the minority stockholders had found the price to be fair.

Even though the Delaware Supreme Court has made broad statements that the entire fairness standard applies to going-private mergers with controlling stockholders, the chancellor found that these did not dictate the result in this case.

Unless the Delaware Supreme Court weighs in, *In re MFW* will provide a road map (outlined below) for a controlling stockholder to take a corporation private in a merger transaction in such a way as to have the transaction obtain business judgment review:

1. The controlling stockholder conditions the transaction on the approval of both a functioning special committee of independent directors and a majority of the minority stockholders.
2. The special committee is independent, able to freely select its own advisors and to say no to the transaction.
3. The special committee takes clear steps to meet its duty of care (e.g. selecting appropriate advisors and meeting an adequate number of times).
4. Sufficient disclosures are made to allow the minority's review of the transaction to be well informed.
5. The controlling stockholder does not take any actions that might be seen as coercive towards the minority stockholders.

In re MFW removes, for now, the difference in the legal tests applied to negotiated mergers and tender offers involving controlling stockholders and provides a consistent approach to such going private transactions. For those controlling stockholders who are willing to condition their deal on approval by a majority of the minority stockholders, this case permits the transaction to be evaluated under the business judgment rule. While there will be times when a controlling stockholder may be unwilling to take this step, presumably the "entire fairness" review will remain as an alternative. ■

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