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Going-Private Transactions May Gain Benefit of Business Judgment Review

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In lawsuits challenging corporate transactions, the standard of review is often determinative. Under the business judgment rule, the decisions of corporate managers are generally presumed to have been made in good faith, and challenges to those decisions should be dismissed unless the plaintiff can plead facts showing that no rational person in good faith could have believed that the transaction was fair.[1] But, when a corporation transacts with an interested party, the court will make a more searching assessment of the "entire fairness" of the transaction.

In those cases, the burden shifts to the defendants to demonstrate that the transaction was both procedurally and substantively fair.[2] Practically speaking, while courts commonly dismiss cases on the pleadings under the business judgment standard, application of the entire fairness review typically precludes dismissal on the pleadings because the defendants bear the burden.[3]

As a result of the more stringent review applied to interested-party transactions, historically it has been virtually impossible to structure a corporate merger with a controlling shareholder in a way that will permit the corporation and its board to obtain dismissal on the pleadings of a complaint challenging the transaction. Going-private transactions and other controlling shareholder mergers were, therefore, usually subject to burdensome and expensive court challenges irrespective of their terms.[4]

The Delaware Chancery Court sought to address this problem last year in a decision subsequently affirmed by the Delaware Supreme Court. The Chancery Court held that a transaction with a controlling shareholder will be subject to business judgment review if it is structured like an arm's-length, third-party merger by conditioning the transaction at the outset on approval by both an independent special committee of the board and a majority of unaffiliated shareholders (a "majority-of-the-minority").[5]

New York law is now following Delaware's lead. In a Nov. 20, 2014 decision in *In re Kenneth Cole Prods.*, the Appellate Division, First Department, applied the business judgment rule and affirmed the dismissal of a challenge to a going-private transaction that the controlling shareholder conditioned on independent committee and majority-of-the-minority approval.[6]

As a result, controlling shareholders of New York corporations, like controllers of Delaware corporations, may now have a predictable road map to significantly reducing the burden of litigating challenges to going-private transactions by structuring those transactions to safeguard minority shareholders' rights.

Background

Prior Law. Before *Kenneth Cole*, New York's appellate courts had not squarely addressed the proper treatment of a going-private merger subject to special committee review and a majority-of-the-minority vote. The leading New York case addressing a transaction with a controlling shareholder remains the Court of Appeals' 1984 decision *Alpert v. 28 Williams St. Corp.* (See Footnote 2). In *Alpert*, the controlling

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shareholders of a corporation "froze out" the minority shareholders in a merger that did not require minority shareholder approval.[7] On those facts, the court in *Alpert* held that the transaction should be reviewed under the entire fairness standard. But the Alpert court explained that "[w]hile the final result" is the same in any transaction in which the controlling shareholder obtains the equity it did not previously control, "it does not necessarily follow that the fiduciary duty owed by the majority to the minority stockholders will be satisfied by the same conduct in each context."[8] Accordingly, the Alpert court expressly declined to hold that entire fairness review should be applied to all corporate transactions with controlling shareholders.

The Kenneth Cole Transaction and the Trial Court Ruling. The Kenneth Cole decision arose from Kenneth Cole's transaction to take his eponymous clothing company private. Before the transaction, Cole owned 46 percent of the company's outstanding shares and controlled 89 percent of the voting power. In February 2012, Cole informed the company's board that he would make a non-binding offer to purchase all shares of the company's stock that he did not already own.

At that time, Cole told the board that he expected it would form an independent special committee to consider the offer, and that he would not go forward unless both the special committee and a majority-of-the-minority approved the deal. The special committee retained independent financial and legal advisors, and met 11 times over the next three-and-a-half months, before approving Cole's offer. After the special committee approved the offer, 99.8 percent of the voting shareholders approved the offer as well.

Inevitably, as in virtually every significant public company transaction, shareholder litigation followed.[9] Indeed, the first shareholder suits were filed within days of Cole's initial offer, before the company or its board had taken any further action. In a purported class action on behalf of the company's public shareholders, a shareholder plaintiff sued Cole and the board for breach of fiduciary duty. The defendants moved to dismiss.

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Cole and the board argued that the transaction included sufficient procedural protections for minority shareholders such that the transaction should be treated as one in which the directors had disinterested independence and, therefore, should be entitled to the protections of the business judgment rule. And under the business judgment rule, the defendants argued, the complaint should be dismissed.

The plaintiff disagreed, of course, arguing that Cole's control over the company meant that no transaction the company entered into with him could reasonably be treated as one at arm's length. In particular, the plaintiff stressed Cole's public statements that, if the company rejected his offer, he would not entertain any offers to sell his shares, effectively eliminating the board's ability to shop for more attractive buyout offers.

The plaintiff also argued that the special committee members were controlled by Cole. The trial court applied the business judgment rule and dismissed the complaint, reasoning that "absent a showing of specific unfair conduct by the special committee," it was bound by the business judgment rule.[10] And while the plaintiff alleged that Cole controlled the special committee members, the court, relying on persuasive Delaware precedent, held that the plaintiff's allegations that the special committee members were nominated or elected to their positions at Cole's behest were not sufficient to plead a lack of independence.

In dismissing the claims against Cole, the court relied on long-standing New York law that "although minority shareholders are entitled to protection from abuse from controlling shareholders, minority shareholders 'are not entitled… to inhibit the legitimate interest of the other stockholders'."[11] Thus, with regard to Cole's refusal to entertain offers for his own shares, the court noted that New York law does not require a controlling shareholder to "acquiesce to any proposed third-party transactions." To the contrary, the court explained that "the ability to resist such a transaction would appear to be one of the benefits of having a controlling position in the company."[12]

Likewise, with respect to the plaintiff's argument that Cole improperly sought to negotiate as low a price as possible for the buyout, the court explained that a controlling shareholder is not "required to subject his own economic interest, in obtaining a low price, to the minority shareholders' interest in obtaining a higher price."[13] The plaintiff appealed.

Business Judgment Rule

In *In re Kenneth Cole*, the First Department affirmed the dismissal and held that, "[c]ontrary to plaintiff's claim," the trial court "was not required to apply the 'entire fairness' standard to the transaction."[14] While the plaintiff had relied heavily on the Court of Appeals' decision in *Alpert* to argue that controlling-shareholder transactions should be reviewed for entire fairness, the First Department disagreed and found that, unlike in *Alpert*, "the merger in the case at bar required the approval of the majority of the minority (i.e. non-Cole) shareholders."[15]

The court noted that, while Cole had a conflict of interest, he did not participate in the board's consideration of the merger. Finally, the court found the plaintiff's allegations that the proxy statement sent to shareholders was incomplete and misleading to be insufficient. As a result, the court held that "[i]n this particular case, pre-discovery dismissal based on the business judgment rule was appropriate since there were no allegations sufficient to demonstrate that the members of the board or special committee did not act in good faith or were otherwiseinterested."

Discussion

Important policy considerations support the rule applied in the Kenneth Cole decision. The business judgment rule arises from the recognition that courts are poorly equipped to second guess the business judgments of corporate managers. Entire fairness review is a limited exception to the rule meant to protect shareholders from corporate decisions infected by conflicts of interest. But a transaction conditioned on approval from both an independent special committee and a majority-of-the-minority vote is analogous to an arm's-length, third-party transaction: The controller is removed from the corporate decision-making process with special committee approval akin to board approval in a third-party merger, and majority-of-the-minority approval akin to approval of all shareholders in a third-party merger. Moreover, providing controllers the benefit of the business judgment rule under these circumstances encourages them to structure transactions in the way most protective of minority shareholder rights.

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Following the recent similar rulings by the Delaware courts, the First Department's decision in *Kenneth Cole* is significant because it provides a road map to New York companies to structure transactions in a way that may permit dismissal of related litigation on the pleadings. It should be noted, however, that the First Department rested its decision in part on the absence of any allegations calling into question the good faith and disinterestedness of the special committee.

Accordingly, companies hoping to gain the benefit of this decision should ensure that the special committee is, in fact, independent and able to effectively negotiate terms with the controlling shareholder. At a minimum, this should mean that the special committee is free to retain independent legal and financial advisors, and has the authority to reject the controlling shareholder's proposal. In addition, because of the requirement of majority-of-the-minority approval, to gain the benefit of the business judgment rule, controlling shareholders will be required to give up control at the outset of the transaction by transferring an effective veto over any deal to minority shareholders.

While the benefits of the business judgment rule may be significant, controllers will face a business decision about whether those benefits are worth the costs of ceding control over the transaction. And controllers who ultimately decide to structure their transactions to gain the benefit of the business judgment rule should be sure to establish a record demonstrating both a truly independent and empowered special committee and appropriate disclosures to minority shareholders allowing an informed vote.

1. See *Auerbach v. Bennett*, 47 N.Y.2d 619, 629 (1979)) (the business-judgment rule "bars judicial inquiry into actions of corporate directors taken in good faith …").
2. See *Alpert v. 28 Williams St. Corp.,* 63 N.Y.2d 557 (1984).
3. See *Orman v. Cullman*, 794 A.2d 5, 20 n.36 (Del. Ch. 2002) (the application of the entire-fairness standard "normally will preclude dismissal of a complaint in a Rule 12(b)(6) motion to dismiss.").
4. See *In re Cox Comm'cns Inc. S'holders Litig.*, 879 A.2d 604 (Del. Ch. 2005) ("Unlike any other transaction one can imagine…it was impossible…to structure a merger with a controlling shareholder in a way that permitted the defendants to obtain dismissal of the case on the pleadings.").
5. *In re MFW S'holders Litig.*, 67 A.3d 496 (Del. Ch. 2013), aff'd *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014). See Joel C. Haims and James J. Beha II, "A Significant Decision for Going-Private Transactions," Law360 (Aug. 22, 2013).
6. *In re Kenneth Cole Prods.,* 2014 N.Y. Slip. Op. 08105, 2014 WL 6475758 (1st Dept. Nov. 20, 2014).
7. *Alpert*, 63 N.Y.2d at 557.
8. Id.
9. For the past several years, over 90 percent of M&A deals valued at over $100 million each resulted in shareholder litigation. Andrew J. Pincus, "Trial Lawyers New Merger Tax," U.S. Chamber Inst. for Legal Reform (Oct. 2012) at 2. Most recently, according to one academic study, almost 98 percent of takeover transactions in 2013 valued at more than $100 million resulted in shareholder litigation. Matthew D. Cain and Steven M. Davidoff, "Takeover Litigation in 2013" (Jan. 9, 2014).
10. *In re Kenneth Cole Prod., Inc. S'holder Litig.*, No 650571 (N.Y. Sup. Sept. 3, 2013) (Doc. No. 126), at 8.
11. Id. at 10 (quoting *Zetlin v. Hansons Hldgs.*, 48 N.Y.2d 684, 685 (1979)).
12. Id. at 10.
13. Id. at 11.
14. 2014 WL 6475758, at *1.
15. Id.