

Delaware Supreme Court Affirms Pleading-Stage Dismissal of Control Stockholder Buyout Litigation

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Embracing the view that control stockholder satisfaction of six-factor “MFW Playbook” in a minority buyout can be determined without extensive disclosure.

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INTRODUCTION

In 2014, in *Kahn v. M&F Worldwide Corp.*, the Delaware Supreme Court affirmed application of business judgment review, as opposed to the more exacting entire fairness standard, to a control stockholder-led buyout conducted in accordance with a six-factor process outlined by the Court.¹ This process involved the dual protections of (1) approval of the transaction by a special board

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1. 88 A.3d 635 (Del. 2014).

committee consisting of independent directors, followed by (2) an affirmative vote of a majority of the minority stockholders.² However, the minority stockholder litigation challenging this buyout was dismissed on a summary judgment motion following extensive discovery, and the Court indicated that a pre-discovery motion to dismiss would not have been granted.³ This created considerable doubt as to the efficacy of the six-factor process.

This doubt was eliminated late last year in *Swomley v. Schlecht*.⁴ In *Swomley*, the Delaware Supreme Court affirmed a Court of Chancery decision granting a control stockholder's motion to dismiss litigation challenging its buyout of minority stockholders.⁵ In sharp contrast to the position staked out by the Delaware Supreme Court in *M&F Worldwide*, the Court of Chancery determined in *Swomley* that the pre-trial record alone sufficiently established the requisites for obtaining business judgment review and granting the control stockholder's motion to dismiss.⁶ In a terse, one-sentence ruling, the Delaware Supreme Court affirmed this judgment, simply "for the reasons stated" by the Vice Chancellor. As such, *Swomley* offers an important tool to control stockholders that will permit them, provided they adhere to the six-factor process, to obtain dismissal of stockholder litigation challenging minority buyouts early in the pleading stage.⁷

I. LEGAL BACKGROUND

As is so often the case with Delaware corporate jurisprudence, to really appreciate the import of a key decision, one must understand the historic landscape. The jurisprudence surrounding control stockholder-led buyouts, which serve as lightning rods for the plaintiffs' bar, is no exception.

A. From Weinberger to MFW

Beginning with the Court's iconic 1983 decision in *Weinberger v. UOP, Inc.*, Delaware courts reviewed challenges to minority buyouts under the exacting entire fairness standard, with the burden of proving

2. *Id.*

3. *Id.*

4. C.A. No. 9355-VCL (Del. Nov. 19, 2015).

5. C.A. No. 9355-VCL (Del. Ch. Aug. 27, 2014).

6. *Id.*

7. This article focuses on control stockholder buyouts structured as *one-step* mergers. Delaware courts have traditionally applied a different standard of review when the buyout is structured with *two* steps, a tender offer followed by a short-form merger.

fairness upon the control stockholder.⁸ As a result, it has been almost impossible for control stockholders to obtain pleading-stage dismissal of lawsuits challenging their transactions. Except in the most egregious cases, settlements involving the payment of attorneys' fees and the granting of universal settlements have been the usual outcome.

In a number of important decisions since *Weinberger*, Delaware courts have given control stockholders the opportunity, *first*, to shift the burden of proof to defendants and, *second*, to obtain the benefits of business judgment review. Generally speaking, this relief has been conditioned on the control stockholder employing structural protections aimed at replicating the arm's-length nature of negotiations between unrelated parties engaged in a potential business combination transaction.

- In 1994, in *Kahn v. Lynch Communications Systems, Inc.*, the Court reaffirmed that “entire fairness” is the “exclusive standard of judicial review” in litigation challenging minority buyouts, with the control stockholder having the burden of proving entire fairness.⁹ However, the Court added that this burden could be shifted to plaintiff stockholders if the transaction is approved by *either* “an independent committee of directors or an informed majority of minority shareholders.”¹⁰

Following *Kahn v. Lynch*, control stockholder-led buyouts generally were conditioned on approval by a special committee of independent directors. Transaction planners were usually reluctant to employ a majority-of-the-minority stockholder vote due, in large measure, to the leverage such a vote could bestow upon a well-organized and vocal minority.

- In 2005, in *In re Cox Communications, Inc. Shareholders Litigation*, then-Vice Chancellor Leo E. Strine, Jr. championed application of business judgment review to minority buyouts when the transaction is approved by *both* an independent board committee *and* a majority of the minority stockholders.¹¹ Underlying this position was the Vice Chancellor's recognition that, under *Kahn v. Lynch*, “absent the ability of the defendants to bring an effective motion to dismiss, every case has settlement

8. 457 A.2d 701, 715 (Del. 1983).

9. 638 A.2d 1110, 1117 (Del. 1994).

10. *Id.*

11. 879 A.2d 604, 606 (Del. Ch. 2005).

value, not for merits reasons, but because the costs of paying . . . attorneys' fees to settle litigation and obtain a release without having to pay the minority stockholders in excess of the price agreed to by the special committee" are less than the costs (and associated risks) inherent in a time-consuming trial on the merits to establish entire fairness.¹²

Nevertheless, because the facts before him did not permit Vice Chancellor Strine actually to invoke the business judgment rule, control stockholders could not rely on the decision for purposes of structuring minority buyouts.¹³ The use of independent board committees continued as the standard structural device.

- Then in 2013, then-Chancellor Strine found an opportunity to follow through on the position he broached in *Cox Communications*. From the earliest days of the transaction that became the focal point of the dispute in *In re MFW Shareholders Litigation*, the control stockholder premised its proposed minority buyout on the approval of *both* a special committee of independent directors *and* an informed vote of a majority of the minority stockholders.¹⁴ Chancellor Strine, applying business judgment review, granted the control stockholder's motion for summary judgment, albeit after what he termed "extensive discovery" by plaintiffs that lasted eight months.¹⁵

In *MFW*, Chancellor Strine offered the hope that making business judgment review available to control stockholders in exchange for enhanced minority protections would provide control stockholders with a means to prevail on an early motion to dismiss, thereby eliminating meritless litigation.¹⁶ Of course, until the Delaware Supreme Court weighed in, deal planners could not be certain that the Chancellor's position would be sustained.

12. See *In re MFW S'holders Litig.*, 67 A.3d 496, 534 (Del. Ch. 2013).

13. *Cox*, 879 A.2d at 647–48.

14. 67 A.3d 496 (Del. Ch. 2013).

15. *MFW*, 67 A.3d at 510.

16. See *id.* at 526–35.

B. Kahn v. M&F Worldwide Corp.

Although the Court affirmed *MFW* in *M&F Worldwide*, its opinion cast doubt on the ability of control stockholders to obtain dismissal at the pleading stage, even if they followed the “*MFW* Playbook.”

First, the Court set forth a specific six-factor process for triggering business judgment review in minority buyouts.¹⁷ According to the Court, the business judgment standard of review will be applied in controller buyouts *if and only if*:

- (i) the controller conditions the procession of the transaction on the approval of both a Special [Board] Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.¹⁸

It is worth noting that the fourth factor, which was added by the Court to Chancellor Strine’s litany of protections in *MFW*, would seemingly require a fact-based analysis.¹⁹

Second, the Court explained that “[i]f a plaintiff can plead a reasonably conceivable set of facts showing” that any of the six factors is not satisfied, “that complaint would state a claim for relief that would entitle the plaintiff to proceed and conduct discovery.”²⁰ If the case subsequently went to trial, “the court will conduct an entire fairness review.”²¹ In other words, “unless *both* procedural protections for the minority stockholders are established *prior to trial*, the ultimate judicial scrutiny of controller buyouts will continue to be the entire fairness standard of review.”²²

Third, in a footnote citing *Americas Mining Corporation v. Theriault*,²³ the Court indicated that it would not be possible, pre-trial, to determine whether an independent committee satisfied the fourth factor by negotiating a fair price.²⁴ In this connection, the Court noted that it could not examine the “substance” and “efficacy” of a committee appropriately “‘on the basis of the pretrial record alone.’”²⁵ And further, in a second footnote, the Court stated that plaintiffs’ complaint in *MFW*

17. *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635, 645 (Del. 2014).

18. *Id.*

19. *See id.*

20. *Id.*

21. *Id.* at 646.

22. *Id.*

23. 51 A.3d 1213 (Del. 2012).

24. *M&F Worldwide*, 88 A.3d at 645 n.13.

25. *Theriault*, 51 A.3d at 1240–41,

would have survived a motion to dismiss.²⁶ The Court found the price “surprisingly low,” calling into question “the adequacy of the Special Committee’s negotiation.”²⁷ This finding reinforced the Court’s point that discovery would be necessary to more fully examine the sufficiency of the negotiations. These references seemingly undercut Chancellor Strine’s position that use of the dual minority stockholder protections could result in early dismissal of minority buyout litigation.

In the aftermath of *M&F Worldwide*, M&A commentators expressed doubt whether deal planners would begin to utilize majority-of-the-minority votes on the off-chance that a court would actually apply the business judgment rule at an early pleading stage. There was genuine concern that Chancellor Strine’s vision of early dismissal of minority buyout litigation through use of the dual minority protections would not be realized. Recently, however, by affirming the Court of Chancery’s dismissal, early in the pleading stage, of stockholder litigation challenging a control stockholder buyout in *Swomley*, the Court appears to have shifted jurisprudential gears.

II. *SWOMLEY V. SCHLECHT*

A. *Factual Background*

In *Swomley*, minority stockholders challenged the cash-out merger of Synqor, Inc., a privately held Delaware corporation controlled by its management.²⁸ The buyout group consisted of Dr. Martin Schlecht and members of Synqor’s senior management, who collectively owned 46% of Synqor’s stock.²⁹ Synqor’s three-person board of directors included Dr. Schlecht and two independent directors.³⁰ In the hope of obtaining business judgment review when minority stockholders brought the inevitable lawsuit, the buyout group structured the transaction to comply with *M&F Worldwide*’s six factors.³¹ The key question before the Court of Chancery was “whether the plaintiffs have

26. *M&F Worldwide*, 88 A.3d at 645 n.14.

27. *Id.*

28. Ruling on Defendants’ Motion to Dismiss at 3, *Swomley v. Schlecht*, No. 9355-VCL (Del. Ch. Aug. 27, 2014). Initially, the Court considered whether the six factors apply in the private corporation context. It stated it did not believe “Delaware law would make a distinction.” Therefore, “the same rules apply to Delaware corporations regardless of whether they’re public or private.” *Id.* at 4–5.

29. *Id.* at 3.

30. *Id.*

31. *Id.* at 3–4.

called into question whether the requirements [of *M&F Worldwide*] were met such that they can proceed beyond the pleading stage.”³²

B. The Court of Chancery’s Analysis

As an initial matter, Vice Chancellor J. Travis Laster considered whether satisfaction of the *M&F Worldwide* factors may even be determined at the pleading stage.³³ Despite the *M&F Worldwide* Court’s indication that it would be problematic for the Court of Chancery to make such a pleading stage determination, the Vice Chancellor expressed his view that “the whole point of encouraging this structure was to create a situation where defendants could effectively structure a transaction so that they could obtain a pleading-stage dismissal”³⁴ Therefore, the six-factor process should “stand up” at the pleading stage unless plaintiff can “plead[] facts that would undermine each of its elements.”³⁵ To satisfy this burden, plaintiffs cannot broadly state they “don’t know today whether [the six factors were] met,” but rather must plead “some type of facts” establishing it is “reasonably conceivable” that the six factors were not satisfied.³⁶

On this basis, Vice Chancellor Laster analyzed whether plaintiffs pled sufficient facts to undermine the buyout group’s compliance with any of the six *M&F Worldwide* factors.³⁷ He concluded they had not, leading him to grant the buyout group’s motion to dismiss.³⁸

In this connection, the Vice Chancellor made the following noteworthy observations: The special board committee was “independent” for purposes of the second factor, despite each member receiving a \$50,000 payment for service on the committee.³⁹ The Vice Chancellor was comforted that the board established this payment “up front” and assured it was not contingent on the transaction’s outcome.⁴⁰ Further, the fact that the buyout group selected the committee was “not enough” to call into question its independence.⁴¹

32. *Id.* at 4.

33. *Id.* at 5.

34. *Id.*

35. *Id.* at 8.

36. *Id.* at 8, 9.

37. *Id.* at 9–16.

38. *Id.* at 16.

39. *Id.* at 9–10.

40. *Id.* at 10.

41. *Id.*

The fourth factor added by the *M&F Worldwide* Court—that the special committee “met its duty of care in negotiating a fair price”—“is measured by a gross negligence standard.”⁴² As such, plaintiff stockholders must plead facts showing “recklessness” or “wanton conduct” on the part of the committee, a “very tough standard to satisfy.”⁴³

The special committee satisfied its duty of care when it “negotiated improvements in the merger price from an initial offer of \$1.10 to a final offer of \$1.35.”⁴⁴ While one may disagree with the “strategy or tactics” the committee employed to reach this price, these decisions are “debatable choice[s]” that do not undermine the committee’s satisfaction of its responsibilities.⁴⁵

With respect to the sixth factor, the “question of coercion is whether you can vote down a deal and keep the status quo,” even if that status quo “may not be attractive.”⁴⁶ Here, the “stockholders were able to vote down the transaction and, for better or for worse, return to the status quo.”⁴⁷

C. *The Supreme Court’s Ruling*

Vice Chancellor Laster dismissed the claims against the Synqor buyout group, to relatively little fanfare, in a bench ruling on August 27, 2014. Nearly 15 months later, the Delaware Supreme Court issued its terse, one-sentence ruling that “the final judgment of the Court of Chancery should be affirmed for the reasons stated in its . . . bench ruling.”⁴⁸

CONCLUSION

By affirming Vice Chancellor Laster’s dismissal of the challenge the Synqor buyout, the *Swomley* Court has confirmed that minority buyout litigation may indeed be dismissed at the pleading stage, so long as the control stockholder properly employs *M&F Worldwide*’s six-factor process. While the procedural benefits of receiving business judgment review were questioned after *M&F Worldwide*, *Swomley* indicates that extensive discovery is not necessarily a prerequisite to a

42. *Id.* at 11.

43. *Id.*

44. *Id.* at 12.

45. *Id.*

46. *Id.* at 14.

47. *Id.* at 15.

48. *Swomley v. Schlecht*, No. 180,2015, 2015 WL 7302260, at *1 (Del. Nov. 19, 2015).

trial court's determination that a control stockholder conducting a minority buyout has satisfied its fiduciary duties. As such, control stockholders and their advisors may now find that employing these six factors offers sufficient procedural benefits in subsequent litigation to justify conditioning minority buyouts on a majority-of-the-minority stockholder vote.