DELAWARE CORPORATE LAW BULLETIN

MFW FRAMEWORK REQUIRES MAJORITY-OF-MINORITY STOCKHOLDER APPROVAL EVEN WHEN CONTROLLER STRUCTURES TRANSACTION TO AVOID STATUTORY STOCKHOLDER VOTE

Chancery Court determines that legal structuring will not immunize control stockholder from application of entire fairness absent implementation of MFW Dual Protections

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INTRODUCTION 158
I. LEGAL BACKGROUND 158
II. FACTUAL BACKGROUND 159
  A. *Inefficiencies of TPB's Corporate Structure* 160
  B. *Merger Negotiations* 160
  C. *The Merger* 161
  D. *Litigation Ensues* 162
III. VICE CHANCELLOR FIORAVANTI'S ANALYSIS 162
  A. *Standard of Review* 162
  B. *Entire Fairness Analysis* 163
CONCLUSION 164

INTRODUCTION

In Berteau v. Glazek, C.A. No. 2020-0873-PAF (Del. Ch. June 30, 2021) ("*Berteau*"), Vice Chancellor Paul A. Fioravanti, Jr. of the Delaware Court of Chancery ("*Chancery Court*") confronted a "novel," but ultimately "unpersuasive," theory concerning the judicial standard of review applicable to a corporate merger involving a controlling stockholder on both sides of the transaction. It goes without saying that mergers involving conflicted control stockholders are the most heavily litigated and judicially scrutinized of all M&A transactions.

I. LEGAL BACKGROUND

As the Chancery Court has observed, control stockholders, with their power to "extract[ ] differential benefits from the corporation at the expense of minority stockholders," owe a fiduciary duty of loyalty and good faith to the corporation and its other stockholders. *See In re EZcorp Inc. Consulting Agreement Deriv. Litig.*, No. 9962–VCL, 2016 WL 301245, at *11 (Del. Ch. Jan. 25, 2016) ("*EZcorp*"), as discussed in Robert S. Reder & Elizabeth F. Shore, *Chancery Court Applies M&F Framework to Transactions in Which Controlling Stockholders Allegedly Received "Unique Benefits*,*"* 72 Vand. L. Rev. En Banc 221 (2019) ("*Reder & Shore*"). Traditionally, the Chancery Court reviewed breach of fiduciary duty claims arising from these transactions under the entire fairness standard—the highest standard of review—" 'with the defendants having the burden of persuasion' " that " 'the transaction was the product of both fair dealing and fair price.' "

This changed with *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) ("*MFW*"), in which the Delaware Supreme Court provided controllers and independent directors with an escape hatch from entire fairness review for properly structured transactions. Under *MFW*, the coercive effect of the controller in conflicted transactions may be neutralized if the transaction is conditioned, *from the outset*, " 'upon both the approval of an independent, adequately empowered Special Committee that fulfills its duty of care, and the uncoerced, informed vote of a majority of the minority stockholders.' " ("*Dual Protections*"). Per *MFW*, successful implementation of the Dual Protections results in judicial review under the highly deferential business judgment rule instead of entire fairness, usually resulting in pleading stage dismissal of breach of fiduciary duty claims.

The rules of the road for obtaining the benefits of the *MFW* defense have been clarified in a host of post-*MFW* decisions. For instance, in *IRA Trust FBO Bobbie Ahmed v. Crane*, No. 12742-CB,

2017 WL 7053964 (Del. Ch. Dec. 11, 2017) ("*Crane*"), as discussed in Reder & Shore, then-Chancellor Andre G. Bouchard "reasoned that the *MFW* framework should be encouraged to protect the interests of minority stockholders in transactions involving controllers, whether it be a squeeze-out merger (*MFW*), a merger with a third party (*Martha Stewart*), or one in which the minority stockholders retain their interests in the corporation (*EZCORP*)." The Chancellor also noted that the *MFW* defense already had been extended from corporate buyouts to other transactions benefitting control stockholders:

> (1) security issuances, purchases, and repurchases; (2) asset leases and acquisitions; (3) compensation arrangements, consulting agreements, and service agreements; (4) settlements of derivative actions; and (5) recapitalizations.

For a summary of *MFW* and subsequent decisions, see Robert S. Reder & Connor J. Breed, MFW*'s Ab Initio Requirement Not Satisfied When Controlling Stockholder Negotiated with Minority Stockholder Before Acceding to "[D]ual [P]rotections,"* 74 Vand. L. Rev. En Banc 397 (2021).

* * *

Berteau addressed the question whether the second prong of the Dual Protections, the majority-of-the-minority stockholder vote, was required for a transaction structured to avoid the stockholder approval requirements of the Delaware General Corporation Law ("*DGCL*") to receive the benefits of *MFW*. Vice Chancellor Fioravanti denied the control stockholder's motion to dismiss, explaining that defendant's argument that a majority-of-the-minority stockholder vote was not required due to the manner in which the transaction was structured "ignores the history of the *MFW* doctrine and what it was intended to address."

II. FACTUAL BACKGROUND

Publicly-traded Turning Point Brands, Inc. ("*TPB*" or "*Company*") "develops, manufactures, markets, and distributes nicotine products, smokeless tobacco products, and smoking accessories." A majority of TPB's common stock was owned by Standard Diversified, Inc. ("*SDI*"), itself a publicly-traded corporation whose "primary asset" was its Company shares. SDI also owned two businesses whose assets ("*Non-TPB Assets*"), collectively, were "comparatively immaterial." SDI, in turn, was majority-controlled by individuals and entities affiliated with Standard General, L.P. (collectively, "*Standard General*"), which manages hedge funds. Of the seven members of TPB's board of directors ("*Board*"), three (including SDI's Chief Executive Officer) also served on

SDI's board of directors ("*SDI Directors*"), and a fourth was TPB's Chief Executive Officer.

A. Inefficiencies of TPB's Corporate Structure

Over time, Standard General found that owning a majority interest in TPB indirectly through its majority interest in SDI "was inefficient." Specifically, "the holding company structure caused SDI's common stock to trade at a significant discount relative to the value of its primary asset—TPB stock—and, in turn, caused TPB's stock to suffer decreased trading liquidity and reduced public float." Further, the holding company structure "generated administrative, managerial, and legal costs."

To address these inefficiencies, in late 2019, "SDI representatives initiated informal conversations with TPB management and members of the . . . [B]oard about a potential merger between TPB and SDI." Following these conversations, SDI provided a term sheet to the Board contemplating a "two-step transaction": *first*, SDI would divest the Non-TPB Assets and, *second*, TPB would "acquire SDI in a stock-for-stock merger 'based on an exchange ratio to be determined.' " By structuring the merger with TPB as the *acquiring* company, only SDI stockholder approval, and not TPB stockholder approval, would be required to under the DGCL.

In response, the Board "established a Special Committee to evaluate the proposed transaction with SDI." This committee ("*Special Committee*"), implemented "to insulate negotiations between TPB and SDI" from the influence of the SDI Directors, consisted of two other TPB directors. The Board "delegated broad powers" to the Special Committee, "including the power to say 'no,' . . . to hire independent legal and financial advisors, and . . . to examine and pursue alternative transactions." Then, on November 18, the two companies "publicly announced" their intention "to 'pursue' a merger."

B. Merger Negotiations

Over the course of the merger negotiations, which continued through early June 2020, SDI sought a "1:1 stock-for-stock exchange ratio," which would be favorable to its stockholders (principally Standard General). Heeding its financial advisor, who calculated that "SDI's stock traded at a 30.2% discount to TPB's stock," the Special Committee sought to pay SDI a discounted value for its TPB shares. Moreover, based on advice of counsel regarding the benefits of satisfying the Dual Protections, the Special Committee proposed that

" 'consummation of the transaction would be subject to the approval of the holders of the majority of outstanding shares of TPB Common Stock not beneficially owned by SDI . . . .' " After initially acceding to this request, SDI ultimately rejected a majority-of-the-minority vote and continued to insist on structuring the transaction to avoid a TPB stockholder vote.

At a meeting held on March 26 between the Special Committee and a one-person committee of the SDI board of directors, the attendees discussed an exchange ratio calling for TPB to issue .99 of a TPB share in exchange for each TPB share owned by SDI. However, two days later, the Special Committee informed the SDI board member "that TPB 'could not proceed' on the terms discussed" at the earlier meeting. This "triggered a flurry of activity that marked the beginning of the end of the Special Committee process." Finally, on March 29, the full Board—including both the SDI Directors and the Special Committee members—met (without outside counsel or the financial advisor in attendance) to discuss a 0.97x stock exchange ratio. This proved to be the final discussion of the exchange ratio.

Following receipt of its financial advisor's fairness opinion, the Special Committee approved the transaction based on a 0.97x stock exchange ratio. The fairness analysis underlying the opinion "indicated that, based on the 0.97x exchange ratio, TPB's stockholders stood to gain 9.9 percent of the transaction's economic benefit, representing $6.9 million," while "SDI and its stockholders obtained the remaining economic benefit of $69 million." In an interesting twist, the financial advisor's fairness opinion "did not specifically address the financial fairness of the transaction to the Company's *minority* stockholders" (emphasis added), but only "fair[ness] to the stockholders of the Company" generally. Further, Company records did not indicate whether "the Special Committee considered a fairness opinion from the perspective of the TPB stockholders unaffiliated with SDI."

C. The Merger

TPB and SDI signed a merger agreement on April 7 ("*Merger Agreement*") and publicly announced the transaction the following day. Two months later, with the transaction still pending, both SDI and funds managed by Standard General sold TPB shares "at $23.50 per share in an underwritten public offering." Of the $40 million received by SDI from the sale, "approximately $16 million [was used] to repurchase shares of SDI . . . common stock from a[ ] Standard General fund," even though the Merger Agreement provided that "SDI would not 'reacquire any shares of its capital stock or other securities' "

pending completion of the transaction. Had these proceeds not been so applied, the cash would have flowed to TPB upon consummation of the merger. Notwithstanding this development, the transaction closed without objection on July 9.

D. Litigation Ensues

Three months later, a TPB stockholder ("*Plaintiff*") challenged the recently completed transaction in the Chancery Court. Among other claims, Plaintiff alleged that Standard General breached its fiduciary duties owing to TPB minority stockholders "as TPB's controlling stockholder" by orchestrating a transaction that " 'was not entirely fair to TPB or its public stockholders.' " Vice Chancellor Fioravanti resolved Standard General's ensuing motion to dismiss in favor of Plaintiff.

III. VICE CHANCELLOR FIORAVANTI'S ANALYSIS

Vice Chancellor Fioravanti described the transaction as "a classic self-dealing transaction involving a controlling stockholder" who "stood on both sides" and "extracted a unique benefit . . . not ratably shared with TPB's other common stockholders." This characterization informed the remainder of the Vice Chancellor's analysis.

A. Standard of Review

The Vice Chancellor began by selecting the applicable judicial standard of review. Typically, " '[w]hen a transaction involving self-dealing by a controlling stockholder is challenged, the applicable standard of judicial review is entire fairness, with the defendants having the burden of persuasion.' " Standard General, however, argued for application of the more lenient business judgment presumption on the basis that the *MFW* "safe harbor" does not "require a majority-of-the-minority vote" in "parent-subsidiary mergers that do not statutorily require a stockholder vote." By structuring the transaction as an acquisition by TPB of SDI, rather than vice versa, the parties "actively sought to avoid any transaction structure that would require the approval of TPB's stockholders" under the DGCL.

In support of this argument, Standard General relied on "dicta" from a case where, in the words of Vice Chancellor Fioravanti, "the same argument was rejected." In *Tornetta v. Musk*, 250 A.3d 793 (Del. Ch. Sept. 20, 2019) ("*Tornetta*"), as discussed in Robert S. Reder & Alexandra N. Bakalar, *Chancery Court Indicates Willingness to Extend M&F to Compensation Award to Controlling Stockholder*," 73 Vand. L.

Rev. En Banc 61 (2020)), an unhappy Tesla, Inc. stockholder challenged the board's grant of an "extraordinary" compensation award to Elon Musk, the company's CEO and controlling stockholder. In determining to apply entire fairness to the process by which Musk received his compensation package, the *Tornetta* Court noted it would have been willing to apply the deferential business judgment standard *if* the Tesla board had satisfied the *MFW* Framework. However, in a footnote, the *Tornetta* Court "remarked that it saw 'nothing in . . . *MFW* . . . to suggest . . . [the] court intended to hold that the dual protections are required in all controlling stockholder transactions in order to reduce the degree of judicial scrutiny paid to the transaction.' "

Vice Chancellor Fioravanti rejected this argument, observing that "*Tornetta* does not mandate—nor even imply—that anything short of the dual protections of *MFW* should be required to lower the standard of review" for the claims brought by Plaintiff. Further, he explained that "*MFW* was designed as a narrow safe harbor for a controlling stockholder transaction to obtain business judgment review at the pleadings stage." Therefore, "[i]ts protections apply even if the challenged transaction is not subject to a statutory vote under the DGCL." The fact that the transaction allegedly was negotiated and approved by "a purportedly independent Special Committee" was irrelevant. Involvement of such a committee, despite its other virtues, alone "is not sufficient to trigger the business judgment rule."

In sum, as the Vice Chancellor explained, "*MFW* was a narrow and carefully cleared path for defendants to follow to obtain a pleadings stage dismissal of a controlling stockholder transaction." By arguing that its careful structuring of the merger to avoid a TPB stockholder vote obviated the need to satisfy the second prong of the Dual Protections, Standard General sought "to turn that path into a highway." The Vice Chancellor was not willing to make this leap.

B. Entire Fairness Analysis

Next, applying an entire fairness review, Vice Chancellor Fioravanti concluded that Plaintiff adequately alleged, for purposes of defeating pleading-stage dismissal, that " 'the transaction was not fair,' " in terms of either *process* or *price*. The Vice Chancellor cited a number of reasonable inferences from Plaintiff's pleadings in support of his conclusion, including that:

- "Standard General successfully interfered with the transaction process."

- "Standard General's propensity to interfere on the SDI side" indicated "that it did not respect the barriers created by the creation of the TPB Special Committee."
- "Standard General decided to end further bargaining between the special committees and to finalize approval" of the transaction through exercise of its power over the Board.
- The decisive Special Committee and Board meetings exhibited "a choreographed and unusually hurried nature," indicating they "were conducted at the behest of the common controller of SDI and TPB."
- The presentation by the Special Committee's financial advisor "indicate[d] that SDI directly competed with TPB's other stockholders over the economic benefit to be achieved" by the transaction.
- Moreover, the stock-for-stock "exchange ratio transferred approximately 90% of the economic benefit derived from the transaction to SDI rather than to TPB's stockholders."

On this basis, the Vice Chancellor denied Standard General's motion to dismiss.

CONCLUSION

The DGCL provides significant flexibility to corporate dealmakers and their legal counsel to structure M&A transactions in a variety of perfectly legal ways. For instance, in *Berteau*, there was no *legal issue* under the DGCL with structuring the desired business combination as an acquisition by TPB of SDI, even though TPB's minority stockholders were given no right to vote on a transaction that directly impacted, arguably in a highly negative manner, their investments in TBP.

However, as a court of equity, the Chancery Court is not limited to a statutory analysis. For instance, when it comes to assigning the applicable—and often outcome-determinative—standard of review when adjudicating breach of fiduciary duty claims, the Chancery Court has significant discretion. In the words of Vice Chancellor Fioravanti, "[t]o accept business judgment review to a controlling stockholder transaction merely because it can be structured to avoid a statutory stockholder vote would, in my view, undermine the entire rationale for the [*MFW*] doctrine." Clearly, when structuring any transaction that may benefit a control stockholder, the only way for dealmakers and their counsel to secure business judgment rule review, and pleading-stage dismissal, of the inevitable breach of fiduciary duty claims is to

satisfy all aspects of the *MFW* framework, including the Dual Protections.