

Reproduced with permission from Corporate Accountability Report, 101 CARE, 5/25/16. Copyright © 2016 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

DELAWARE LAW

New York Adopts Delaware Standard for Going-Private Transactions



BY MICHAEL C. HEFTER, RYAN M. PHILP AND
DAVID R. KOLKER

Michael C. Hefter is the head of the civil trial section in Bracewell LLP's New York office and the global co-head of the firm's securities litigation practice group. His practice focuses on complex commercial disputes, including claims involving breach of contract, breach of fiduciary duty, fraud, and other business disputes arising under federal and state law.

Ryan M. Philp is Senior Counsel in Bracewell's trial section. He concentrates his practice on complex corporate and commercial disputes, with a particular focus on shareholder and creditor disputes, including class and derivative actions arising out of M&A transactions, contests for corporate control and other securities and corporate governance matters.

David R. Kolker is an associate in the litigation section of Bracewell's New York office. He focuses on trial and appellate work in general commercial litigation, securities litigation, internal investigations, bankruptcy, and white-collar matters in state and federal court.

On May 5, 2016, the New York Court of Appeals affirmed the dismissal of a shareholder class action and formally adopted the standard of review for going-private transactions articulated by the Delaware Supreme Court in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) (*MFW*). The decision in *Matter of Kenneth Cole Productions, Inc., Shareholder Litigation*, No. 54 (N.Y. May 5, 2016), confirms that the deferential business judgment standard of review will apply to going-private transactions under New York law if certain shareholder-protective conditions are present (88 CARE, 5/6/16).

Case Summary

This lawsuit arose from a going-private merger between Kenneth Cole Productions, Inc. (KCP) and its founder and controlling shareholder, Kenneth Cole. Slip Op. at 2. Cole sat on KCP's five-member board of directors and held 89 percent of the company's shareholder voting power. *Id.* In February 2012, he announced his intention to purchase all outstanding shares to take KCP private. *Id.* at 2-3. The board created a special committee consisting of the other four board members to consider Cole's proposal. *Id.* at 3. On February 23, 2012, Cole submitted an offer of \$15.00 per share conditioned on approval by (i) the special committee, and (ii) a majority of KCP's minority shareholders. *Id.* After retaining independent counsel and advi-

sors, the special committee engaged in negotiations with Cole and eventually recommended his offer of \$15.25 per share to the minority shareholders, who ultimately approved it by a vote of 99.8 percent. *Id.* at 4.

Prior to the board's approval, several shareholders filed class action lawsuits (which were consolidated) seeking to enjoin the merger and alleging, *inter alia*, that Cole and the board had breached their fiduciary duties. *Id.* 3-4. The Supreme Court granted the defendants' motion to dismiss, holding that the plaintiffs did not demonstrate that the special committee members lacked independence or that Cole or the board had breached their fiduciary duties. *Id.* at 4-5. The Appellate Division affirmed. *Id.* On appeal, the Court addressed what standard should apply to a going-private merger that is conditioned from the outset on approval by both an independent special committee and a majority-of-the-minority vote. *Id.* at 6. Following *MFW*, the Court held that the business judgment rule should apply if certain conditions are met; otherwise, the much more rigorous entire fairness standard should apply. *Id.*

The Court's Reasoning

The Court began by recognizing the general principle under New York law that courts should avoid interfering with the internal management of corporations. *Id.* at 6. Thus, New York courts, like Delaware courts, long have applied the business judgment rule, pursuant to which courts generally defer to the unbiased, good faith decisions of corporate officers and directors. *Id.* However, the Court recognized that freeze-out mergers, which usually implicate divided or compromised loyalties, call into question the application of that rule. *Id.* at 7. In its seminal decision in *Alpert v. 28 Williams St. Corp.*, 63 N.Y.2d 557 (1984), the Court held that the more exacting entire fairness standard applied to a two-step merger involving common directors or majority ownership between the transaction parties. *Id.* at 8.

The Court also recognized that this case presented the same question addressed by the Delaware Supreme Court in *MFW*—specifically, what standard applies to a going-private merger conditioned from the start on approval by *both* an independent committee and a majority-of-the-minority vote. *Id.* at 10 (citing *MFW*, 88 A.3d at 639). The Court stated that allowing for the application of the business judgment standard incentivizes majority shareholders to protect the minority in a freeze-out merger by incorporating the double protections of an independent special committee and an informed majority-of-the-minority vote. *Id.* at 10-11 (citing *MFW*, 88 A.3d at 643). The Court thus adopted the *MFW* standard in its entirety, holding that the business judgment rule, rather than the entire fairness standard, “ ‘will be applied *if and only if*: (i) the controller conditions the procession of the transaction on the approval of both a Special 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 to 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.’ ” *Id.* at 11-12 (quoting *MFW*, 88 A.3d at 645) (emphasis in original). Applying that standard to the facts, the Court reasoned that the plaintiffs failed to show that any of these conditions were missing, and thus affirmed the lower court's decision. *Id.* at 16-17.

Takeaways

In *Kenneth Cole*, the New York Court of Appeals confirmed that New York law provides a path to business judgment review for going-private transactions provided they are conditioned at the outset on approval by a special committee of independent directors and a fully-informed, uncoerced majority-of-the-minority vote. In so holding, the Court reaffirmed New York's longstanding recognition that courts generally should not interfere with unbiased, good-faith management decisions.

Going forward, New York corporations structuring going-private transactions will need to weigh the benefits of business judgment rule protection potentially achieved by following the ‘MFW’ framework against the deal uncertainty that ‘MFW’s minority shareholder protections may create.

By adopting the standard articulated in *MFW*, the Court also reaffirmed that, in the absence of controlling or contrary New York precedent, New York courts often will look to Delaware law as persuasive authority. Thus, in many instances, the well-developed body of Delaware corporate law may lend some predictability to decisions applying New York law.

In particular, *Kenneth Cole* suggests that New York courts will turn to Delaware decisions with respect to the application of the *MFW* standard. These Delaware decisions demonstrate that, in certain circumstances, the application of *MFW* may yield the dismissal of shareholder actions at the pleading stage, prior to expensive plenary discovery. However, they also demonstrate that the standard provides no guarantee of business judgment review and, absent scrupulous observance of the *MFW* framework, shareholder complaints still may survive a motion to dismiss.

Therefore, going forward, New York corporations structuring going-private transactions will need to weigh the benefits of business judgment rule protection potentially achieved by following the *MFW* framework against the deal uncertainty that *MFW’s* minority shareholder protections may create. To the extent a company prizes deal certainty over the mitigation of litigation risk, it may elect to disregard the *MFW* framework, understanding that shareholder litigation is a near certainty. On the other hand, a company that wishes to minimize litigation risk to the greatest extent possible may elect to follow the *MFW* framework, understanding that a special committee or the company's minority shareholders may reject the deal. The decision of what course to pursue necessarily will depend on the facts and circumstances of the corporation and the transaction. However, the New York Court of Appeals' decision to adopt the *MFW* framework at least provides New York corporations with the option to pursue a path to

ward business judgment rule protection, which, in turn, may mean that the company and its officers and direc-

tors avoid years of expensive and burdensome shareholder litigation.