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'Modified' Business Judgment Rule for Going-Private Transactions

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A large body of law addresses corporate decision-making, particularly where a board of directors decides "yea or nay" on a merger transaction. When litigation ensues, the standard of judicial review that applies for determining the validity of the transaction is critical. The well-known "business judgment rule" gives great leeway to a corporation's board. However, in certain circumstances, a more exacting "entire fairness" standard governs. In its recent opinion in *In re Kenneth Cole Productions, Inc., Shareholder Litigation*,[1] the New York Court of Appeals, following Delaware's lead, announced a new approach for reviewing going-private mergers derived from these two standards. Specifically, the court held that the board-friendly business judgment rule should apply to the challenge of a going-private merger if certain shareholder-protective conditions are met. The opinion sets forth a road map for how parties can structure such a merger to pass legal muster.

Transaction and Lawsuit

The litigation involves the well-known fashion business founded by Kenneth Cole, organized as a New York corporation named Kenneth Cole Productions, Inc. (KCP). KCP had two classes of common stock, class A (entitling the holder to one vote) and class B (entitling the holder to 10 votes). Kenneth Cole held approximately 46 percent of the class A shares and all of the class B ones. These interests gave Cole 89 percent of the shareholder voting power. Cole served on the board of directors. The class A shareholders elected two other directors. Class A and Class B shareholders together elected two more directors, enabling Cole as sole owner of the class B shares effectively to control those two director slots.

In February 2012, Cole announced his intention to offer to purchase the class A shares he did not own. This would take publicly held KCP private. In response (and without Cole being present at the meeting), the board created a special committee to consider Cole's proposal and negotiate a possible merger. The committee consisted of the four directors other than Cole.

Shortly afterwards, Cole made an offer at $15 per share. He conditioned the offer on approval from both the special committee and a majority of the minority shareholders. Cole advised that he did not want to seek any other type of merger; that as a shareholder, he would not approve of one; and that if his proposal failed to receive approval from either the special committee or the other shareholders, his relationship with the company would not be adversely affected.

The special committee, after retaining counsel and a financial advisor, negotiated the deal terms with Cole. Eventually, Cole offered $15.25 for each class A share. The committee recommended this offer, and virtually all of the minority shareholders (99.8 percent) voted in favor of the merger.

Nonetheless, some shareholders brought class actions (which were ultimately consolidated), naming as defendants KCP, Cole, the directors, and entities related to the proposed merger. Plaintiffs sought a declaration that Cole and the directors had breached their fiduciary duties owed to the minority shareholders, damages for the class, and judgment enjoining the merger. Defendants moved to dismiss for failure to state a cause of action.

The trial court granted the motion, and the Appellate Division, First Department, affirmed.[2] In particular, the First Department rejected the shareholders' contention that the entire fairness standard had to be applied to the transaction, instead upholding dismissal based on the business judgment rule. Signaling importance, the Court of Appeals granted leave to appeal.[3]

The Court's Analysis

The Court of Appeals framed the issue as follows: "what standard should be applied by courts reviewing a going-private merger that is subject from the outset to approval by both a special committee of independent directors and a majority of the minority shareholders." Plaintiff—referring to the lead plaintiff following consolidation of actions—again argued for the entire fairness standard, "which places the burden on the corporation's directors to demonstrate that they engaged in a fair process and obtained a fair price." Defendants invoked the business judgment rule, which requires courts to defer to determinations by officers or directors "made in good faith," where based on "unbiased judgment in determining that certain actions will promote the corporation's interests."

The court adopted neither standard per se. Rather, it endorsed a "middle ground": that "the business judgment rule should be applied as long as the corporation's directors establish that certain shareholder-protective conditions are met; however, if those conditions are not met, the entire fairness standard should be applied."

The court began its analysis with the "general principle" that New York courts typically should not interfere with the internal management of business corporations—essentially, the underpinning of the business judgment rule. The rule is driven by three considerations: (i) courts are ill-equipped to evaluate business judgments; (ii) no objective standard exists to measure the correctness of many corporate decisions; and (iii) corporate directors are charged with the authority to make the decisions.

As a consequence, the court emphasized, "absent fraud or bad faith, courts should respect those business determinations and refrain from any further judicial inquiry." Nonetheless, while the substantive determination of a committee of disinterested directors is beyond judicial review, "the court may inquire as to [1] the disinterested independence of the members of that committee and…[2] the appropriateness and sufficiency of the investigative procedures chosen and pursued by the committee."

That limited but important review comes into play in a "freeze-out merger," where the majority shareholder or a control group "attempts to freeze out the interests of the minority shareholders." A freeze-out merger is "typical of situations in which a director's loyalty may be divided or compromised," possibly making the business judgment rule inapplicable. The court noted three types of freeze-out mergers: (i) two-step mergers, where an outside investor acquires majority control and then uses that control to merge the target with another company; (ii) parent-subsidiary mergers; and (iii) going-private mergers, "in which the majority shareholder seeks to remove public investors and gain ownership of the entire company," as in *Cole*.

The court addressed whether its "seminal decision" on freeze-out mergers, *Alpert v. 28 Williams St. Corp*.,[4] applied to the merger in *Cole*. *Alpert* had adopted the entire fairness standard for the two-step merger at issue there. That case, the court in *Cole* explained, recognized "the inherent conflict of interest and the potential for self-dealing" where there are common directors or majority ownership between the parties to the merger. In that scenario, "careful scrutiny of the transaction" is required. That means that when an inherent conflict of interest exists, the burden shifts to the interested directors or shareholders "to prove good faith and the entire fairness of the merger." The entire fairness standard, which requires both fair process and fair price, is decidedly more rigorous than the business judgment rule. However, the court noted that *Alpert* did not decide whether the entire fairness standard applied to mergers other than a two-step one, such as the going-private merger in *Cole*.

The Cole court determined that a going-private transaction should be analyzed under the test recently established by the Delaware Supreme Court in *Kahn v. M&F Worldwide Corp.* (*MFW*).[5] As Cole court described it, *MFW* involved a controlling shareholder's offer to acquire all of the company's stock, contingent on (i) negotiation and approval by a special committee comprised of independent directors; and (ii) approval by a majority of the shareholders who were unaffiliated with the controlling shareholder.

Prior Delaware cases had applied the entire fairness standard to mergers involving interested directors, imposing a burden shift on the objecting minority shareholders where the interested director predicated the offer on approval from either a special committee or a majority of the minority shareholders. Before *MFW*, the Delaware Supreme Court had not prescribed the standard of review where both of those shareholder protections existed.

Cole accepted the Delaware Supreme Court's reasoning that when both protections exist, the "situation replicates an arm's length transaction and supports the integrity of the process." Thus, structuring a going-private merger with these protections for minority interests permits a court to apply the business judgment rule.

Following *MFW*, *Cole* expanded on the conditions for applying the business judgment rule in a controller buyout transaction: (i) the controller must condition the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee must be independent; (iii) it must be empowered to select its own advisors freely and to say no definitively; (iv) it must meet its duty of care in negotiating a fair price; (v) the minority cannot be coerced; and (vi) its vote must be informed. All of these conditions must be met for the business judgment rule to apply; if not, the standard is entire fairness review.

Cole held that because plaintiff failed sufficiently to allege that any of these conditions were absent, the business judgment rule applied. The court thus affirmed dismissal of the complaint.

Ramifications

Cole outlines how a controller and a corporation can avail themselves of the business judgment rule when a shareholder challenges a going-private transaction. The transaction must be structured with dual approvals—that is, approval from both a special committee and (by majority vote) the minority shareholders. These approvals should be part of the transaction from the outset, not a fallback resorted to once a challenge is lodged. The circumstances of the offer must support integrity of the approvals, making approval beyond reproach. That means that the special committee must be genuinely independent; its members cannot have any conflict of interest (such as share ownership), and they cannot be subject to undue influence or bias (such as having business interests with the controller).

Independent, expert advice from M&A counsel and an investment banker can support the bona fides of the proposed transaction, particularly as to the key—and often contested—question of the transaction's fairness. Negotiation by the board/company with the controller normally should occur, to assure that the best price is realized for the minority shares being acquired. Of course, the negotiations must be real, not subject to a claim of pretext. Along these lines, the board might seek third-party offers as a "check" on the controller's offer (although obtaining third-party offers might prove difficult where a controller can block another's proposed merger). The parties should also provide complete, accurate and detailed disclosure in the offering documents, to assure that the minority's vote is fully informed. Improper disclosure is a frequent ground for challenge, and in most instances the more—and the more price-justified—disclosure, the better.

Of course, a dissenting shareholder can be expected to "drill down" into the circumstances of the offer, in an effort to show that the approval process is flawed. That is, as a "how to" for structuring a transaction, *Cole* also readily spotlights how the dissident can find fault with the transaction and thereby assert the more plaintiff-friendly entire fairness standard. And that, in turn, suggests that New York courts can be expected to scrutinize change-of-control transactions carefully against the six fact-specific approval criteria.

In any event, *Cole's* new standard—essentially a clearer picture for when the business judgment rule can be applied to review a going-private transaction—will promote prompt resolution and concrete direction for litigation over these mergers. At the pleading level, *Cole* emphasized that a complaint must have factual specificity, not conclusory allegations or bare legal assertions, on the six shareholder-protective conditions. If pleaded adequately, to survive summary judgment a plaintiff must show that there is a question of fact on the existence or efficacy of any of the conditions. And if the plaintiff can prove that any of the conditions were not in place, the merger will be scrutinized under the entire fairness standard, not the business judgment rule.

Finally, *Cole* is instructive on two broader considerations that litigants and their counsel should keep in mind. Albeit modified in *Cole*, the Court of Appeals reaffirmed the business judgment rule as the default standard, recognizing that New York courts generally should steer clear of second-guessing corporate decision-making, absent a showing of fraud or bad faith. In addition, the court's opinion—particularly since it followed *MFW* without any qualification—highlights the significant influence that Delaware law can have for New York (and other state's) mergers and acquisitions law.

In short, as a result of *Cole*, New York corporations, boards and shareholders now have a clearer path for structuring going-private transactions, and courts and litigants likewise have a clearer path for resolving challenges to them.

Endnotes:

1. Slip op. No. 54, 2016 WL 2350133 (N.Y. May 5, 2016) (Stein, J.).

2. 2013 WL 4767369 (Sup. Ct. N.Y. Cty. Sept. 3, 2013), aff'd, 122 A.D.3d 500 (1st Dept. 2014).

3. 25 N.Y.3d 909 (2015).

4. 63 N.Y.2d 557 (1984).

5. 88 A.3d 635 (Del. 2014).