



Who's In Control Here?

The Delaware Supreme Court reminds boards to act in the interests of all stockholders first, especially in situations involving a controlling stockholder.

BY DOUG RAYMOND AND TODD SCHILTZ

In almost all situations, the board has wide latitude when making decisions. Intended to encourage risk-taking and to prevent stockholders and others from second-guessing board action, the “business judgment rule” creates a strong presumption that board decisions are made in the best interests of the business and company. If stockholders disagree with board decisions, their usual recourse is to vote out the directors with whom they disagree, not to sue them. As a consequence, courts generally will not interfere with a board’s decision unless it lacks any rationally conceivable basis. However, when a

board considers a transaction between the corporation and a controlling stockholder, the directors have to confront issues that are not present in a typical transaction, including the possibility that a controller will seek to short-circuit or improperly influence the board’s evaluation and approval of the transaction.

Under core principles of corporate law, the directors owe duties of care and loyalty to the corporation and all stockholders, not only the controlling one. To ensure that a controlling stockholder does not obtain an unfair benefit at the expense of the corporation and its other stockholders, the presump-

tion of the business judgment rule does not apply to a transaction between the corporation and a controlling stockholder. Delaware courts instead review transactions between a controller and the corporation under the exacting “entire fairness” standard of review. Entire fairness requires the controller and the board to prove that the controller transaction arose from a fair process and that the price paid was fair. Under this analysis, courts will evaluate the timing of the transaction; how it was initiated, structured, negotiated and disclosed to the directors; and how the approvals of the directors and the stockholders were obtained. The fair price analysis focuses on economic and financial considerations. Proving that a controller transaction is entirely fair imposes a significant burden on the board and the controller, and makes it difficult to re-

solve litigation, particularly at early stages, such as a motion to dismiss.

The entire fairness standard is consequently a significant limitation on the board’s latitude and can impose a difficult burden on directors and controllers. Recognizing this, the Delaware courts have ruled that, in certain circumstances, the burden to prove unfairness can shift to the plaintiff and, in other circumstances, the standard of review applicable to controller transactions can shift back to business judgment.

- In *Kahn v. Lynch Communication Systems*, the Delaware Supreme Court held that, if the challenged transaction was conditioned on approval by a well-functioning, independent committee of directors or on the approval of an informed majority of minority shareholders, then the burden of proving

the challenged transaction is unfair shifts to the challenging plaintiffs.

- In *Kahn v. M&F Worldwide Corp. (MFW)*, the Delaware Supreme Court moved away from entire fairness where a controlling stockholder sought to acquire the remaining equity in the company held by the unaffiliated minority stockholders. The court held that the business judgment rule (and not entire fairness) applies when:
 - o A controlling stockholder conditions a merger transaction from the start on the approval of both a special committee and a majority of the minority stockholders.
 - o The special committee is independent.
 - o The special committee is fully empowered.
 - o The special committee meets its duty of care.
 - o The vote of the minority is informed.
 - o There is no coercion of the minority.

MFW thus cleared the way for controllers and directors involved in controller freeze-out mergers to gain pleading-stage dismissal of complaints and endorsed the “best practice” of employing procedural tools to replicate arm’s length bargaining.

Following *MFW*, there has been uncertainty about whether the business judgment standard could be expanded beyond mergers to other controller transactions, such as board approval of a service agreement with a controller or the compensation paid to the CEO/majority stockholder. In particular, it has been argued that a board should obtain the benefits of the business judgment presumption in controller transactions approved by an independent board committee, but without a vote of minority stockholders where that vote was not necessary under corporate law (unlike a merger transaction, where a shareholder vote is generally required).

In the recent case of *In re Match Group Inc. Derivative Litigation*, the Delaware Supreme Court answered this open question. It held that the business judgment rule can apply to non-merger controller transactions only if all the elements identified in *MFW* are present. The court also clarified that each and every member of the special committee must be wholly independent of the controller for *MFW* to apply. Consequently, even if a board composed of a majority of independent directors (or an independent special committee of the board) approves a controller transaction but the other elements of *MFW* are not satisfied, the transaction remains subject to the entire fairness standard of review. While the court resolved these issues, there still remain unresolved questions concerning the impact on a director’s independence of nonfinancial relationships between a controller and the director (such as strong “personal ties of re-

spect, loyalty and affection”) and even the precise parameters of who is a controlling shareholder, promising the potential for further litigation in this important area of governance.

While boards may not frequently desire to submit a transaction to a shareholder vote where their approval is not otherwise necessary under corporate law, *In re Match Group Inc. Derivative Litigation* is an important reminder that, even where there is a controlling stockholder, the board’s obligation is to act in the best interest of all the stockholders. And when the controller engages in transactions with the corporation, the board should be prepared to demonstrate this or to ask the unaffiliated stockholders to approve. ■

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