Business Judgment Rule, Board's Ouster of CEO Affirmed

Court spells out standards for business judgment rule in controller buyouts; finds fault in CEO's acquiescence.

By Francis G.X. Pileggi and Kevin F. Brady

Editor's note: Following the successful relaunch of "Delaware Watch" in the March/April issue, we welcome noted lawyers Francis G.X. Pileggi and Kevin F. Brady to provide ongoing, in-depth analysis on developments in cases from Delaware's highly influential courts that are worthy of directors' consideration.

The case of *Kahn v. M&F Worldwide Corp.*, decided March 14, involved MacAndrews & Forbes, a holding company led by Chairman and CEO Ronald O. Perelman that owned 43 percent of M&F Worldwide (MFW). MacAndrews & Forbes offered to purchase the rest of the corporation's equity in a going-private merger in 2011 for $24 per share. But in a unique upfront move, MacAndrews & Forbes said it would not proceed with any going-private transaction that was not approved by an independent special committee and a vote of a majority of the stockholders unaffiliated with the controlling stockholder.

A special committee was formed that selected its own legal and financial advisors, and met and negotiated with MacAndrews & Forbes, which eventually agreed to raise its bid by $1 per share to $25 per share (a 47 percent premium). The merger was then approved by an affirmative vote of the majority (65 percent) of the minority MFW stockholders.

Stockholders filed lawsuits against MacAndrews & Forbes, MFW, and their directors, including Perelman, alleging that the merger was unfair. The defendants moved for summary judgment arguing that there is no material issue of fact because:

- the MFW special committee was comprised of independent directors;
- the committee had the right to and did engage qualified legal and financial advisors to inform itself whether a going-private merger was in the best interests of MFW's minority stockholders;
- the committee was fully empowered to negotiate with Perelman over the terms of his offer and to say no definitively if it did not believe the ultimate terms were fair to the MFW minority stockholders;
- the committee, after an extensive period of deliberation and negotiations, approved a merger agreement with Perelman; and
- a majority of the minority stockholders supported the merger upon full disclosure and without coercion.

The question of what standard of review should apply to this situation had never been put directly to either the Delaware Court of Chancery or the Delaware Supreme Court. In *Kahn v. Lynch* in 1994, the Delaware Supreme Court held that the approval by either a special committee or the majority of the non-controlling stockholders of a merger with a buying controlling stockholder would shift the burden of proof under the entire fairness standard from the defendant to the plaintiff.

Although *Lynch* did not involve a merger conditioned by a controlling stockholder on both procedural protections, *Lynch* suggested that a controlling stockholder that consented to both procedural protections for the minority would receive no "extra legal credit" for doing so, and that regardless of employing both procedural protections, the merger would be subject to review under the entire fairness standard.

Based on these *ab initio* key procedural protections that together replicate an arm's-length merger, the defendants argued that the business judgment rule should be the judicial standard of review, which would preclude the court from inquiring into the substantive fairness of the merger, and require the court to dismiss the challenge to the merger unless the merger's terms were so disparate that no rational person acting in good faith could have thought the merger was fair to the minority.

The Delaware Supreme Court affirmed the state chancery court's decision, granting summary judgment to the defendants under the business judgment standard of review.

The Supreme Court noted that "[f]or the combination of an effective committee process and majority-of-the-minority vote to qualify (jointly) for business judgment review, each of these protections must be effective singly to warrant a burden shift."

The Supreme Court found that in controller buyouts, the business judgment standard of review will be applied if and only if:

- the controller conditions the procession of the transaction on the approval of both a special committee and a majority of the minority stockholders;
- the special committee is empowered to freely select its own advisors and to say no definitively;
- the special committee is independent;
- the special committee meets its duty of care in negotiating a fair price;
- the vote of the minority is informed; and
- there is no coercion of the minority.

No Prior Notice Required

A recent decision by the Delaware Supreme Court shed light on the principles applicable to a board's action to remove the CEO. The case of *Klaassen v. Allegro Development Corp.*, rendered in March, involved a board whose members included Eldon Klaassen, the majority stockholder, company founder and CEO, as well as directors appointed by large investors.

At some point, the outside directors determined that the CEO needed to be removed. With some advance planning, Klaassen, as the holder of a majority of voting stock, could have removed a majority of the directors, but he was given no notice that the board would be voting on his ouster at its next regular meeting. The court also determined that corporate directors are not required to give notice of *regular* board meetings.

There being no such notice requirement for regular board meetings, it follows that there is no requirement that directors give advance notice of a specific agenda item to be addressed at a regular board meeting. By contrast, however, directors are entitled to advance notice for special board meetings. The ouster of the CEO in this case, however, took place at a regular board meeting.

Another twist was that the directors gave false information to the CEO about what would be discussed at the meeting. Still, that deceit did not impact the outcome. Although the court emphasized that it did not approve of the use of deception as a means of conducting the affairs of a Delaware corporation, the state Supreme Court did not address the merits of the claim by the ousted CEO that the board meeting was allegedly invalid because the other directors employed deceptive tactics in connection with planning and conducting the board meeting.

The opinion also found that even though other directors had discussed their plans to fire the CEO at prior gatherings, those gatherings of some directors were not official special meetings, nor were any formal decisions made at those meetings, and, therefore, no notice was required to be given to all directors of those gatherings.

Klaassen remained a director and a majority stockholder after his ouster as CEO. He was denied relief based on an equitable defense known as "acquiescence." Allegro sought this affirmative defense on the grounds that Klaassen had acted in an "inequitable way by proceeding too slowly."

In sum, because the CEO did not take sufficiently prompt action, such as filing a lawsuit immediately to contest his ouster, the court determined that his equitable claim that he was ousted unfairly was barred by acquiescence; that is, his failure to challenge the actions more swiftly. It must be emphasized that the decision did not address whether the ousted CEO's claims of unfairness would have merit if they were not defeated by the defense of acquiescence. D

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