DELAWARE CORPORATE LAW BULLETIN

Chancery Court Again Grants Early Dismissal of Litigation Challenging Control Stockholder-Led Buyout

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Chancery Court determines buyout followed "M&F Framework" even though initial offer failed to condition transaction on board committee and disinterested stockholder approval

INTRODUCTION

In 1983, the Delaware Supreme Court announced in *Weinberger v. UOP, Inc.*[1] that challenges to control stockholder-led buyouts would be reviewed under the exacting entire fairness standard, with the difficult burden of proving fairness borne by the control stockholder and defendant directors.[2] A little over ten years later, in *Kahn v. Lynch*

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1. 457 A.2d 701 (Del. 1983).

2. *Id.* at 710. Establishing entire fairness requires proof of *both* fair dealing and fair price. *Id.* at 711.

Communications Systems, Inc. ("*Kahn v. Lynch*"),[3] the Delaware Supreme Court reaffirmed that entire fairness remained the "exclusive standard of judicial review," but added that the burden of proof could be shifted to plaintiff stockholders if the transaction was approved by *either* "an independent committee of directors or an informed majority of minority shareholders."[4] Thereafter, control stockholder-led buyouts generally were conditioned on approval by a special committee of independent directors. Transaction planners understandably were reluctant to seek a majority-of-the-minority stockholder vote due, in large measure, to the leverage such a vote bestows on a well-organized, vocal minority.

Beginning in 2005, in a series of decisions, the Delaware Court of Chancery ("*Chancery Court*") questioned whether control stockholder-led buyouts should be reviewed under the less intrusive business judgment rule, at least when the transaction is approved by *both* an independent board committee *and* a majority of the public stockholders.[5] Underlying this consideration was a recognition that "absent the ability of the defendants to bring an effective motion to dismiss, every case has settlement value, not for merits reasons, but because the costs of paying . . . attorneys' fee[s] to settle litigation and obtain a release" are less than the costs and associated risks inherent in a time-consuming trial on the merits to establish entire fairness.[6]

This process culminated in 2013 with the Chancery Court's ruling in *In re MFW Stockholders Litigation*[7] ("*MFW*"). The *MFW* Court determined that, when a control stockholder, from the earliest days of a transaction, conditions a proposed buyout on approval by *both* a special committee of independent directors *and* an informed vote of a majority of public stockholders, the transaction will be reviewed under the deferential business judgment rule.

The Delaware Supreme Court affirmed *MFW* the following year in *Kahn v. M&F Worldwide Corp.*[8] ("*M&F Worldwide*"). The *M&F Worldwide* Court laid out a six-factor process (the "*M&F Framework*") as a condition for granting business judgment review of a control stockholder-led buyout:

"The [control stockholder] conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders;

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3. 638 A.2d 1110 (Del. 1994).
4. *Id.* at 1117.
5. *See, e.g.*, *In re* Cox Commc'ns Inc. S'holders Litig., 879 A.2d 604 (Del. Ch. 2005).
6. *See In re* MFW S'holders Litig., 67 A.3d 496, 534 (Del. Ch. 2013).
7. *Id.*
8. 88 A.3d 635 (Del. 2014).

the Special Committee is independent;

the Special Committee is empowered to freely select its own advisors and say no definitively;

the Special Committee meets its duty of care in negotiating a fair price;[9]

the vote of the minority is informed; and

there is no coercion of the minority."[10]

However, in a potential blow to the utility of the M&F Framework, the Supreme Court's decision cast doubt on defendants' ability to obtain dismissal *at the pleading stage*. Among other factors, the *M&F Worldwide* Court noted that the posture of the lower court's dismissal was a summary judgment motion which followed an extensive eight-month discovery process. This led commentators to question whether deal planners would utilize majority-of-the-minority stockholder votes (in addition to a special board committee) on the off-chance that a Delaware court might actually grant pleading-stage dismissal rather than require extensive discovery and perhaps a trial on the merits.

It did not take long for the Chancery Court to dispel this concern:

The very next year, in *Swomley v. Schlecht*[11] ("*Swomley*"), the Chancery Court determined that *the pre-trial record alone* was sufficient to establish compliance with the M&F Framework. As such, the Chancery Court applied business judgment review in granting a control stockholder's motion to dismiss. Subsequently, in a terse one-sentence ruling, the Delaware Supreme Court affirmed *Swomley*, announcing that "the final judgment of the Court of Chancery should be affirmed for the reasons stated in its . . . ruling."[12]

Then, in October 2016, in *In re Books-A-Million Stockholders Litigation* ("*Books-A-Million*"),[13] Vice Chancellor J. Travis Laster noted that when "defendants have described their adherence to the elements identified in *M&F Worldwide* 'in a public way suitable for judicial notice, such as board resolutions and a proxy statement,' then [the]

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9. *Id*. at 645. This factor, added by the *M&F Worldwide* Court to the procedures outlined in the *MFW* opinion, would seemingly require a fact-based analysis.

10. *Id*.

11. Transcript of Oral Argument, Swomley v. Schlecht (No. 9355-VCL), (Del. Ch. Aug. 27, 2014), 2014 WL 4470947, *aff'd*, 128 A.3d 992 (Del. 2015). For a discussion of *Swomley*, see Robert S. Reder & Lauren Messonnier Meyers, *Delaware Supreme Court Affirms Pleading-Stage Dismissal of Control Stockholder Buyout Litigation*, 69 VAND. L. REV. EN BANC 17 (2016).

12. Swomley v. Schlect, 128 A.3d 992, 992 (Del. 2015).

13. *In re* Books-A-Million, Inc. S'holders Litig., No. 11343-VCL, 2016 WL 5874974 (Del. Ch. Oct. 10, 2016), *aff'd sub nom*, Rousset v. Anderson , No. 515, 2016, order (Del. May 22, 2017). For a discussion of *In re Books-A-Million*, see Robert S. Reder, *Delaware Court Grants Pleading-Stage Dismissal of Litigation Challenging Control Stockholder-Led Buyout*, 70 VAND. L. REV. EN BANC 217 (2017).

court will apply the business judgment rule at the motion to dismiss stage.' "[14] As with *Swomley*, the Delaware Supreme Court affirmed *Books-A-Million* in a terse, one-sentence order.[15]

With the ability of defendants to obtain pleading-stage dismissal under *M&F Worldwide* now seemingly firmly established, the Chancery Court has moved to clarify various aspects of the M&F Framework. Earlier this year, in *In re Synutra International, Inc. Stockholder Litigation* ("*Synutra*"),[16] Vice Chancellor Laster issued an order clarifying, among other things, operation of the M&F Framework's so-called "*ab initio* requirement" calling for the control stockholder to announce that the transaction is subject to approval by a special board committee and disinterested stockholders "before any negotiations took place."[17]

I. FACTUAL BACKGROUND

Xiung Meng and her husband Liang Zhang (the "*Buyer Group*") indirectly owned 63.5 percent of the stock of Synutra International, Inc. (the "*Company*") and also served as the Company's CEO and Board Chair. The Buyer Group initiated a buyout of the minority stockholders in January 2016. The Buyer Group's initial proposal (the "*Initial Proposal*") delivered to the Company's board of directors (the "*Company Board*"), offering $5.91 per Company share, did not condition the transaction on compliance with the M&F Framework.

Upon advice of counsel, the Company Board declined to " 'substantively evaluate' the proposal" at its initial meeting, and instead formed a special committee of purportedly independent directors (the "*Special Committee*") to negotiate with the Buyer Group.[18] Before any negotiations took place, the Buyer Group submitted a revised proposal that "expressly conditioned the transaction on the approval of the Special Committee and a majority of the minority stockholders" (the "*Revised Proposal*").[19] Ultimately, the Special Committee succeeded in negotiating an increase in the buyout price to $6.05 in cash per Company share. The transaction subsequently was approved by both the Special Committee and the minority stockholders.

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14. *In re Books-A-Million*, 2016 WL 5874974, at *8 (quoting Transcript of Oral Argument at *20, Swomley v. Schlecht, No. 9355-VCL, 2014 WL 4470947).

15. *Rousset*, No. 515, 2016, order (Del. May 22, 2017).

16. *In re* Synutra Int'l, Inc. S'holders Litig., C.A. No. 2017-0032 (Del. Ch. Feb. 2, 2018).

17. *Id.* at *3 (quoting Transcript of Oral Argument at *21, Swomley v. Schlecht, No. 9355-VCL, 2014 WL 4470947).

18. *Id.* at *4.

19. *Id.*

A dissatisfied stockholder challenged the transaction on behalf of a putative class, alleging the transaction "resulted from breaches of fiduciary duty by the Buyer Group and the Special Committee."[20] Specifically, plaintiff claimed the Buyer Group failed to follow the M&F Framework in several respects:

First, plaintiff argued that the Buyer Group violated the *first* prong of the M&F Framework because the Initial Proposal did not satisfy the "*ab initio* requirement."[21] Plaintiff also argued that the Revised Proposal came too late to correct this defect.

Second, plaintiff challenged satisfaction of the *third* prong of the M&F Framework, complaining "the Buyer Group's refusal to support a competing bid" from a third party "impaired the Special Committee's ability to say no."[22] As is typical of control stockholder-led buyouts, the Buyer Group advised the Company Board that they would refuse to sell their majority stake to any third party who might issue a superior competing bid.

Third, plaintiff claimed the Special Committee was not disinterested and independent as required by the *second* prong of the M&F Framework. In this regard, plaintiffs complained about (i) the Buyer Group's ability, as the Company's majority stockholder, to replace any director as it saw fit; and (ii) payment of a monthly fee of $12,500 to each member of the Special Committee during the pendency of the transaction.

Fourth, plaintiff alleged that the Special Committee, in negotiating with the Buyer Group, particularly over the buyout price, failed to satisfy its duty of care as mandated by the *fourth* prong of the M&F Framework.

Defendants moved to dismiss on the basis that the transaction indeed satisfied the M&F Framework. Vice Chancellor Laster, consistent with *Swomley* and *Books-A-Million*, ordered dismissal at the pleading stage.

II. VICE CHANCELLOR LASTER'S ANALYSIS

In framing his order granting dismissal of all claims against defendants, Vice Chancellor Laster addressed, one-by-one, plaintiff's assertions that the buyout failed to satisfy various prongs of the M&F Framework:

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20. *Id*. at *1.
21. *Id*. at *3.
22. *Id*. at *5.

With respect to the *first* prong—the "*ab initio* requirement"—the Vice Chancellor noted that the Buyer Group delivered the Revised Proposal "just over two weeks after it first proposed the [transaction], before the Special Committee ever convened and before any negotiations ever took place."[23] This was sufficient, from the Vice Chancellor's point of view, to "prevent[ ] the Buyer Group from using the *M&F Worldwide* conditions as bargaining chips" to negotiate the terms of its buyout proposal and, therefore, to satisfy the "*ab initio* requirement."[24]

The only potential flaw in the process was the Company Board's decision to allow its "long-time counsel" to represent the Buyer Group in the transaction.[25] While it "would have been preferable, both optically and substantively, for the Buyer Group to retain its own counsel," the Special Committee's retention of experienced counsel "fully capable of going head-to-head" with the Buyer Group's counsel relieved any concern that the process for retaining counsel "undercut the Special Committee's effectiveness."[26]

With respect to the *third* prong—the ability of the Special Committee to just say no—the Vice Chancellor explained that "[t]he Buyer Group 'had no duty to sell its block, which was large enough, as a practical matter, to preclude any other buyer from succeeding unless it decided to become a seller.' "[27] Nevertheless, this "did not disable the Special Committee from being able to say no or render the *M&F Worldwide* process ineffective."[28] In fact, this is precisely the type of concern that the M&F Framework addresses in seeking to "best protect [ ] minority stockholders."[29]

With respect to the *second* prong—the independence and disinterestedness of the Special Committee—the Vice Chancellor explained the Buyer Group's "involvement in selecting each of the directors is insufficient to create a reasonable doubt about their independence"[30] In effect, a control stockholder's ability to remove directors from the board does not mean that otherwise independent directors are controlled by that stockholder. Further, payment of fees to the Special Committee was not problematic because the fees were

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23. *Id.*
24. *Id.*
25. *Id.* at *4–5.
26. *Id.* at *5.
27. *Id.* at *6.
28. *Id.*
29. *Id.*
30. *Id.* at *7 (quoting White v. Panic, 793 A.2d 365, 366 (Del. Ch. 2000), *aff'd*, 782 A.2d 805, 816 (Del. 2001)).

neither tied to a specific outcome, "excessive" nor "strikingly disproportionate to the services provided."[31]

With respect to the *fourth* prong—the fulfillment by the Special Committee of its duty of care—the Vice Chancellor noted that the standard for establishing such a breach is "gross negligence." To satisfy this high bar, "plaintiff must plead and prove that the defendant was 'recklessly uninformed' or acted 'outside the bounds of reason.' "[32] In determining that plaintiff's challenges to the transaction process "do not support an inference of gross negligence," the Vice Chancellor cited a number of factors, including that the Special Committee met fifteen times over ten months, "retained its own legal and financial advisors," "conducted a market check, which included contacting thirteen potential strategic buyers and twelve potential financial buyers," negotiated an increase in the buyout price to a level representing "a 58% premium to the Company's unaffected stock price," and obtained favorable deal terms such as "a reduced termination fee" and "a go-shop provision."[33]

CONCLUSION

Synutra presented the Chancery Court, as a follow-up to *Swomley* and *Books-A-Million*, with another opportunity to offer guidance to M&A practitioners and dealmakers on how to structure control stockholder-led buyouts to satisfy the M&F Framework and obtain pleading-stage dismissal. Of particular note in *Synutra* was the ability of the Buyer Group to satisfy the "*ab initio* requirement" for conditioning the transaction on special committee and disinterested stockholder approval even though it failed to check that box in its initial offer letter. While satisfaction of the M&F Framework is a fact-intensive determination, it is certainly helpful to have additional Chancery Court analysis in this highly litigious area.

31. *Id*. at *8.

32. *Id*. at *12 (quoting Albert v. Alex. Brown Mgmt. Servs., Inc., No. Civ.A. 762-N, 2005 WL 2130607, at *4 (Del. Ch. Aug. 26, 2005)).

33. *Id*. at *13.