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Because buyout followed "M&F Framework," court not troubled by existence of higher third-party offer that was rejected by control stockholders

INTRODUCTION

Control stockholder led-buyouts of public company stockholders,[1] commonly referred to as "going private" transactions,

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1. This article focuses on control stockholder led-buyouts structured as *one-step* mergers. Delaware courts have traditionally applied a different (but increasingly consistent) standard of

long have been lightning rods for litigation in the Delaware courts. This litigation generally comes in one of two varieties: (i) class actions asserting breach of fiduciary duty by the control stockholder and target company directors, and (ii) appraisal actions under section 262 of the Delaware General Corporation Law. Consequently, there is no shortage of important decisions explaining the Delaware courts' approach to handling disputes generated by these buyouts.

The judicial standard for reviewing control stockholder-led buyouts in Delaware has undergone an interesting evolution over the last 30-plus years. At the beginning of this period, the operative standard of review was entire fairness, with a heavy burden placed on defendants to prove fairness. The specter of an entire fairness review generally resulted in defendants agreeing to a settlement, rather than incurring the costs and risks of drawn-out litigation. By contrast, since 2013, defendants who properly structure their transactions can obtain the benefits of the more deferential business judgment rule.

Recently, in October 2016, the Delaware Court of Chancery ("*Chancery Court*") updated this evolutionary process. In *In re Books-A-Million, Inc. Stockholders Litigation*[2] ("*Books-A-Million*"), the Chancery Court demonstrated that defendants who properly structure a control stockholder-led buyout may achieve pleading-stage dismissal of stockholder litigation, despite the court's traditional skepticism toward these transactions.

I. LEGAL BACKGROUND: CONTROL STOCKHOLDER-LED BUYOUTS

In 1983, the Delaware Supreme Court announced in *Weinberger v. UOP, Inc.*[3] 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.[4] A little over ten years later, in *Kahn v. Lynch Communication Systems, Inc.* ("*Kahn v. Lynch*"),[5] the Delaware Supreme Court reaffirmed that entire fairness remained the "exclusive standard of judicial review," but

review when the buyout is structured with *two* steps, a tender offer followed by a short-form merger. *See In Re* Pure Res., Inc. S'holders Litig., 808 A.2d 421 (Del. Ch. 2002). Further, according to the Delaware Supreme Court, "the same rules apply to Delaware corporations regardless of whether they're public or private." Transcript of Oral Argument, No. 9355-VCL, 2014 WL 4470947 (Del. Ch. Aug. 27, 2014), *aff'd*, 128 A.3d 992 (Del. 2015).

2. *In re* Books-A-Million, Inc. S'holders Litig., C.A. No. 11343-VCL, 2016 WL 5874974 (Del. Ch. Oct. 10, 2016).

3. 457 A.2d 701 (Del. 1983).

4. This also established that entire fairness requires proof of *both* fair dealing and fair price. *Id.* at 711.

5. 638 A.2d 1110 (Del. 1994).

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."[6] Thereafter, as a direct consequence of this decision, control stockholder-led buyouts generally were conditioned on approval by a special committee of independent directors. Transaction planners 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 and vocal minority.

In 2005, the Chancery Court began to question 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.[7] Underlying this consideration was a recognition that "absent the ability of defendants to bring an effective motion to dismiss, every case has settlement value, not for merits reasons, but because the cost[s] 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.[8]

Then, in 2013, the Chancery Court ruled for the first time in *In re MFW Stockholders Litigation*[9] ("*MFW*") 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 light of the business judgment rule. It must be noted, however, that even though the *MFW* court granted defendant's motion for summary judgment, that ruling followed "extensive discovery" by plaintiffs that lasted eight months.[10]

The Delaware Supreme Court affirmed *MFW* the following year in *Kahn v. M&F Worldwide Corp.*[11] ("*M&F Worldwide*"). The *M&F Worldwide* court willingly permitted business judgment review of a control stockholder-led buyout structured to comply with the following six-factor process ("*M&F Framework*"):

i. "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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6. *Id.* at 1117.
7. *See, e.g.*, *In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604 (Del. Ch. 2005).
8. *See In re* MFW S'holders Litig., 67 A.3d 496, 534 (Del. Ch. 2013).
9. *Id.* at 536.
10. *See id.* at 510.
11. 88 A.3d 635 (Del. 2014).

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;[12]
v. the vote of the minority is informed; and
vi. there is no coercion of the minority."[13]

At the same time, important aspects of the *M&F Worldwide* opinion cast doubt on the ability of defendants, going forward, to obtain dismissal *at the pleading stage*, even if they adhere to the M&F Framework:

- *First*, the court explained that "[i]f a plaintiff can plead a reasonably conceivable set of facts showing" that any of the six factors is not satisfied, "that complaint would state a claim for relief that would entitle the plaintiff to proceed and conduct discovery." In other words, "unless *both* procedural protections for the minority stockholders are established *prior to trial*, the ultimate judicial scrutiny of controller buyouts will continue to be the entire fairness standard of review."[14]
- *Second*, in a footnote citing an earlier Delaware Supreme Court decision,[15] the court suggested it would not be possible, *pre-trial*, to determine whether an independent board committee satisfied the fourth element of the M&F Framework by negotiating a fair price. In this connection, the opinion noted that a court cannot examine the "substance" and "efficacy" of a committee appropriately "on the basis of the *pre-trial* record alone."
- *Third*, in a second footnote, the court stated that plaintiffs' complaint in *MFW would have survived* a motion to dismiss.[16]

These references seemingly undercut the *MWF* court's indication that use of the dual minority stockholder protections could result in early dismissal. In the aftermath of *M&F Worldwide*, mergers and acquisitions commentators expressed doubt that deal planners would utilize majority-of-the-minority stockholder votes in control

12. This factor, added by the *M&F Worldwide* court to the procedures outlined in the *MFW* opinion, would seemingly require a fact-based analysis.

13. *Id.* at 645.

14. *Id.* at 645-46.

15. *Id.* at 645 n.13 (citing Ams. Mining Corporation v. Theriault, 51 A.3d 1213, 1241-44 (Del. 2012)).

16. *Id.* at 645 n.14.

stockholder-led buyouts 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*[17] ("*Swomley*"), the Chancery Court determined that *the pre-trial record alone* was sufficient to establish compliance with the M&F Framework. As such, the 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 the Chancery Court's decision in *Swomley*, announcing that "the final judgment of the Court of Chancery should be affirmed for the reasons stated in its ... ruling."[18] *Books-A-Million* demonstrates the practical impact of the *Swomley* affirmance, and will no doubt serve as a model for dealmakers and practitioners to follow in structuring future control stockholder-led buyouts.

II. FACTUAL BACKGROUND: *BOOKS-A-MILLION*

Books-A-Million, Inc. ("*BAM*") "operates over 250 bookstores, principally in the southeastern United States," and also "sells books over the internet," "owns a majority stake in a yogurt business," and "develops and manages real estate" through a ninety-five percent-owned entity.[19] Members of the Anderson family ("*Andersons*" or "*Anderson Family*") owned "approximately 57.6% of the Company's outstanding voting power."[20] The five-person BAM board of directors ("*Board*") included two Andersons and three other directors, none of whom were affiliated with the Andersons or members of BAM management.

In 2012, the Andersons proposed to buy the minority stockholder interest in BAM at a price of $3.05 per share ("*2013 Proposal*"), representing a twenty percent premium over the trading price at the time. A special committee of the Board formed to consider the offer "concluded that the proposal undervalued the Company" and asked the Andersons to raise.[21] Instead, following further negotiations, the Andersons withdrew their offer. The following year and into 2014, BAM

17. *See* Transcript of Oral Argument, No. 9355-VCL, 2014 WL 4470947 (Del. Ch. Aug. 27, 2014), *aff'd*, 128 A.3d 992 (Del. 2015). For a discussion of the *Swomley* decision, 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).

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

19. *In re* Books-A-Million, Inc. S'holders Litig., C.A. No. 11343-VCL, 2016 WL 5874974 at *1 (Del. Ch. Oct. 10, 2016).

20. *Id.*

21. *Id.* at *2.

held discussions with a potential third party buyer that offered $4.21 per share. Due to the Andersons' unwillingness to sell their shares, however, these talks floundered and then ended.

Then, in January 2015, the Andersons once again proposed to purchase the BAM shares they did not already own ("***2015 Proposal***") "for $2.75 per share in a negotiated transaction," a price representing a "64% premium over BAM's closing price the day of the bid . . . ."[22] Clearly, the Andersons were advised by competent counsel well-versed in the M&F Framework. The 2015 Proposal provided not only that the Andersons expected the Board "to establish a special committee of independent directors with its own financial and legal advisors" to consider the proposal, but stated also that "any definitive acquisition agreement would need to include a non-waivable majority of the minority vote condition."[23] Finally, and presumably to discourage competing bids from third parties, the 2015 Proposal stated that the Anderson Family was "only interested in acquiring the shares that it did not already own and that it was not interested in selling its shares to a third party."[24]

Following receipt of the 2015 Proposal, the Board established a special committee of independent directors ("*Special Committee*"), which in turn retained legal and financial advisors. The Board's authorizing resolutions gave the Special Committee relatively broad powers, including the right to "review, evaluate and negotiate other strategic options available to the Company."[25] The resolutions also provided that "the Board would not approve the proposal without a favorable recommendation from the Special Committee."[26] With its advisory team in place, the Special Committee decided to "evaluate alternative transaction structures" and "to solicit offers for BAM from various other parties."[27] Although this approach yielded a higher third-party offer of $4.21 per share ("*Third Party Offer*"), this offer failed to go forward when the Andersons reminded the Special Committee's financial advisor that they were "only interested in acquiring the shares [they] did not already own and [were] not interested in selling [their] shares."[28]

But the Special Committee did use the Third Party Offer to pressure the Andersons to increase their bid. In response, the

22. *Id.* at *3.
23. *Id.*
24. *Id.*
25. *Id.* at *4.
26. *Id.*
27. *Id.*
28. *Id.* at *5.

Andersons raised their offer to $3.10 per share, but "conditioned on a right to terminate the transaction if more than 5% percent of the Company's stockholders sought appraisal."[29] Ultimately, following more negotiations, the Andersons further increased their bid to $3.25 per share and raised the appraisal condition to ten percent. The Special Committee, and then the Board, accepted the revised proposal. On July 13th, acquisition vehicles formed by the Andersons entered into a merger agreement with BAM. At the stockholders meeting held on December 8th, BAM stockholders owning "approximately 66.3% of the shares who were not affiliated with the Anderson Family" voted in favor of the transaction.[30] The transaction closed two days later.

Several BAM stockholders challenged the transaction in the Chancery Court, alleging breach of fiduciary duty on the part of the Andersons and the other members of the Board. Defendants moved to dismiss on the basis that "plaintiffs' complaint has not pled grounds to take the transaction outside of the *M&F Worldwide* framework."[31] Vice Chancellor J. Travis Laster, consistent with *Swomely*, granted defendants' motion despite the early stage of the proceedings.

III. VICE CHANCELLOR LASTER'S ANALYSIS

Vice Chancellor Laster focused his analysis on the judicial standard of review applicable to defendants' conduct. He noted that while "entire fairness" traditionally was the standard "when a controlling stockholder takes a company private," in the wake of *M&F Worldwide*, "the business judgment rule would provide the operative standard of review if the controller satisfied the ... [six elements]" of the M&F Framework.[32] Moreover, the Vice Chancellor explained 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 [a] court will apply the business judgment rule at the motion to dismiss stage...."[33]

On this basis, Vice Chancellor Laster concluded that plaintiffs' contentions "do not support a reasonably conceivable inference that any of the *M&F Worldwide* conditions were not met."[34] Accordingly, he

29. *Id.*
30. *Id.* at *6.
31. *Id.* at *1.
32. *Id.* at *8.
33. *Id.* (quoting Transcript of Oral Argument, Swomley v. Schlecht, No. 9355-VCL, 2014 WL 4470947 at *20 (Del. Ch. Aug. 27, 2014)).
34. *Id.*

granted defendants' motion to dismiss without requiring further discovery or a trial on the merits.

In the course of explaining his decision, Vice Chancellor Laster made several noteworthy observations concerning compliance with various elements of the M&F Framework:

- To defeat satisfaction of the *first element*,[35] plaintiffs argued that the 2015 Proposal "was a continuation of," and therefore should be linked with, the 2013 Proposal. Unlike the latter, the former was not conditioned on independent committee and minority stockholder approval. The Vice Chancellor did not view plaintiffs' continuation theory as a "reasonably conceivable inference" from the facts before him: the two proposals involved "a different price and different terms" handled through a "separate process,"[36] and the 2013 Proposal terminated when it was rejected by a special Board committee.
- With respect to the *second element*,[37] plaintiffs complained that a BAM director who had disqualified himself from the Special Committee nevertheless attended a Special Committee meeting held to receive the financial advisor's final report. This was done as a matter of convenience—to avoid a second presentation for only one director—because this director was the only non-Anderson Family Board member not serving on the Special Committee. While the Vice Chancellor remarked that "a truly pristine process" would have involved the financial advisor "giv[ing] its presentation twice," this factor alone did "not support a reasonably conceivable inference" that the Special Committee's independence was compromised.[38]
- Plaintiffs also argued that the Special Committee's acceptance of the final price offered by the Andersons "disloyally favored the interests of the Anderson Family" and, therefore, constituted bad faith, undermining satisfaction of the *second element*. Specifically, plaintiffs

35. The control stockholder must condition the transaction on approval of both a special board committee and a majority-of-the-minority stockholder vote. *See supra* note 13.

36. *In re* Books-A-Million, Inc. S'holders Litig., C.A. No. 11343-VCL, 2016 WL 5874974 at *9 (Del. Ch. Oct. 10, 2016).

37. The members of the special committee must be independent. *See supra* note 13.

38. *In re* Books-A-Million, Inc. S'holders Litig., C.A. No. 11343-VCL, 2016 WL 5874974 at *8 (Del. Ch. Oct. 10, 2016).

complained about the Special Committee's failure to pursue the Third Party Offer, which exceeded the Andersons' offer by $0.96 per share, or nearly thirty percent, after it was rejected by the Andersons.[39] Rejecting these concerns, the Vice Chancellor explained:

- The Andersons "did not breach any duty to the corporation or its minority" either by rejecting the Third Party Offer or "by proposing a going-private transaction at a substantial premium to the market price."[40]
- The Special Committee was not required, nor was it even permitted, to "deploy[ ] corporate power *against* the Anderson Family to facilitate a third-party deal" by, for instance, issuing stock to a third party to dilute the Anderson's equity position.[41]
- Because the Special Committee explored "third-party offers to test whether the members of the Anderson Family would stick to their buyer-only stance" and "to assess the value of the Company and determine whether the Anderson Family's bid was so low as to warrant rejecting it outright without presenting it to the minority," "[r]ather than supporting an inference of bad faith, the Committee's actions support an inference of good faith."[42]
- One "can reasonably infer" that the Third Party Offer "was higher because the [third party] was seeking to acquire control and ... the Anderson Family's offer was lower because it took into account the family's existing control over the Company."[43]
- However, if "the amount of the minority discount was extreme, then one might infer that the independent directors sought to serve the interests of the controller, confident that stockholders focused on short-term gains would

39. *Id.* at *12.

40. *Id.* at *15.

41. *Id. See* Mendel v. Carroll, 651 A.2d 297 (Del. Ch. 1994).

42. *In re* Books-A-Million, Inc. S'holders Litig., C.A. No. 11343-VCL, 2016 WL 5874974 at *15 (Del. Ch. Oct. 10, 2016).

43. *Id.* at *16.

approve any transaction at a premium to market. This is not such a case, because the bargained-for consideration falls within a rational range of discounts and premiums."[44]

- The Special Committee "rationally could believe that stockholders might prefer liquidity at a premium to market."[45]

- The *fourth element*[46] requires "alleged facts supporting a reasonably conceivable inference that the directors were grossly negligent."[47] According to the Vice Chancellor, such an inference was not supported by a credible process involving thirty-three Special Committee meetings, five months of negotiations with the Andersons, a search for "additional information in the form of third-party expressions of interest," and active negotiations over price and other terms resulting in a "price 20% higher than the Anderson family's initial offer" and "more than 90% above BAM's closing price."[48]

CONCLUSION

Once again, as in *Swomley*, the Chancery Court has confirmed in *Books-A-Million* that control stockholder-led buyout litigation may indeed be dismissed at the pleading stage—without extensive discovery or a trial on the merits and despite indications to the contrary by the Delaware Supreme Court in *M&F Worldwide*—so long as the control stockholder properly employs the M&F Framework. Moreover, Vice Chancellor Laster's analysis of the process employed by the Special Committee to negotiate and ultimately approve the Andersons' buyout proposal offers significant guidance in terms of future transactions. While every transaction will stand or fall on the basis of its own unique facts, the Vice Chancellor's refusal to link the 2013 Proposal and the 2015 Proposal, or to require the Special Committee to take affirmative steps to derail the buyout in light of a higher third-party bid, should be instructive to deal planners and their advisors.

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44. *Id.*

45. *Id.* at *17.

46. The special committee must satisfy its duty of care in negotiating a fair price. *See supra* note 13.

47. *In re* Books-A-Million, Inc. S'holders Litig., C.A. No. 11343-VCL, 2016 WL 5874974 at *9 (Del. Ch. Oct. 10, 2016).

48. *Id.* at *18.

POST-SCRIPT

On May 22nd, the Delaware Supreme Court affirmed Vice Chancellor Laster's ruling granting the Books-A-Million defendants' motion to dismiss.[49] Following the pattern of its affirmance of a similar ruling in *Swomley*, the court's order was simply one sentence, stating in pertinent part that the lower court ruling "should be affirmed on the basis of and for the reasons assigned by the Court of Chancery in its Memorandum Opinion of October 10, 2016."[50]

49. Rousset v. Anderson, No. 515, 2016, 2017 WL 2290066 (Del. May 22, 2017).
50. *Id.* at *1.