

Clients & Friends Memo

Delaware Court of Chancery Extends Business Judgment Rule Deference to Controller Transactions Involving Third-Parties

August 23, 2017

On August 18, 2017, the Delaware Court of Chancery granted defendants' motion to dismiss a class action brought by former minority stockholders of Martha Stewart Living Omnimedia, Inc. ("MSLO") against Martha Stewart and Sequential Brands Group, Inc. ("Sequential"). In his opinion in [*In re Martha Stewart Living Omnimedia, Inc. Stockholder Litigation, C.A. No. 11202-VCS \(Del. Ch. Aug. 18, 2017\)*](#), Vice Chancellor Slight's held that the business judgment rule, rather than the entire fairness standard, applied at the pleadings stage to a challenge to a controlling stockholder's sale to a third party, applying the Delaware Supreme Court's seminal holding in *Kahn v. M&F Worldwide Corp.* ("MFW") to such "single-side" controller transactions. Chancellor Slight's ruling represents the first time the business judgment rule has been applied to single-side controller transactions at the pleadings stage pursuant to the MFW framework; prior decisions involved situations where the controller was on both sides of the transaction.

Critically, the Court found that the dual procedural protections of approval by an independent special committee of the board and a majority of minority shareholders must be in place prior to the onset of a conflict developing in the context of negotiating the transaction rather than from the outset of any negotiations at all. Even though it ultimately found that "side deals" Stewart negotiated with Sequential did not actually amount to a conflict with minority stockholders, the Court found that business judgment rule deference nonetheless would have been appropriate even if a conflict existed because the MFW protections were in place prior to when the potential conflict arose, *i.e.*, when Sequential first sought to negotiate "side deals" with Stewart. Throughout the MSLO opinion, the Court emphasized that without strict adherence to the MFW road map, the business judgment rule would not apply to one-sided transactions involving a controlling stockholder.

Background

Founded in 1996 by Martha Stewart, MSLO was a publicly traded company engaged in publishing, broadcasting, and merchandising for homemakers and other consumers. In November 2014, the largest stockholder of Sequential, Tengram Capital Partners, expressed interest in exploring a transaction with MSLO and shortly thereafter transmitted a written statement of preliminary interest

to Stewart. Stewart, in turn, provided the statement to a Special Committee of the MSLO Board, which had been formed earlier that year in response to an expression of interest in an acquisition from another company ("Company A"). Later that month, Sequential proposed a transaction with MSLO for \$6.20 per share. On May 11, 2015, Sequential submitted a revised proposal of \$6.25 per share if MSLO could renegotiate the contract with its publishing partner, Meredith Corporation, or, if MSLO did not renegotiate the contract, Sequential proposed to pay \$5.75 per share.

One day later, on May 12, 2015, the Special Committee's outside counsel advised that Sequential sought to negotiate the terms of Stewart's post-closing arrangements, as Company A had done, while simultaneously negotiating the terms of the transaction with the Special Committee. The Special Committee authorized Stewart to negotiate her post-closing arrangements, subject to the Committee's ability to approve or reject those arrangements before making any recommendation regarding the transaction to the full MSLO board. Despite MSLO's inability to renegotiate the Meredith contract, Sequential submitted yet another bid on June 5, 2015, with alternative prices of \$6.15 per share or \$6.00 per share, with the former including a no-shop provision and the latter permitting a post-merger agreement go-shop period. Ultimately, Sequential and the Committee settled on the higher \$6.15/share price *and* a thirty-day post-signing go-shop period. On June 21, 2015, after the Special Committee's financial advisor provided a fairness opinion, the Special Committee voted unanimously to recommend the transaction, including Stewart's "side deals," to the full MSLO Board. On June 22, 2015, the full Board, with Stewart recusing herself, approved the transaction. On December 2, 2015, 99% of MSLO's minority stockholders approved the transaction.

In addition to the terms of the MSLO transaction, Sequential negotiated Stewart's post-closing arrangements with respect to her employment, intellectual property, and registration rights. With respect to Stewart's employment agreement, Sequential agreed that Stewart would serve as Chief Creative Officer for the post-transaction company, with \$1.8 million in annual compensation plus a potential bonus. Stewart also was entitled to receive variable percentages of gross revenues from sales of Stewart-branded products, \$100,000 per year in reimbursements for certain expenses, and up to \$4 million reimbursement for costs associated with negotiating her post-closing arrangements.

Three days after the board approved the sale, on June 25, 2015, plaintiffs filed suit against Stewart for breach of fiduciary duty as MSLO's controlling stockholder and against Sequential for aiding and abetting a breach of fiduciary duty. Plaintiffs alleged that Stewart's agreements with Sequential were "side deals" that diverted consideration away from minority stockholders for Stewart's benefit. Rejecting plaintiffs' claims, the Court, applying the *MFW* framework to a single-side controller transaction, found that the Special Committee was independent and effective and that the majority of the minority voting condition was established prior to the start of negotiations between Stewart and Sequential; therefore, the business judgment rule applied.

The *MSLO* opinion is notable in several respects: the Court applied *MFW* to single-side controller transactions for the first time; provided further guidance regarding when, in the course of negotiations, the *MFW* transaction conditions must be in place; discussed appropriate special committee action when considering a sale of the company; addressed the type of controller “side deals” that rise to the level of creating a conflict with minority stockholders; and offered important instruction on certain litigation tactics.

Takeaway and Analysis

Plaintiffs’ allegations with respect to Stewart’s alleged conflict relied upon a “false narrative” that the Court rejected even at the motion to dismiss stage.

Plaintiffs insisted that Sequential’s final purchase price of \$6.15 per share illustrated that Stewart’s “side deals” diverted consideration away from minority shareholders when compared to the initial purchase offer of \$6.20 per share; however, Sequential had lowered its offer based upon a failure to renegotiate the Meredith publishing contract: “Sequential did not lower its offer after completing negotiations with Stewart; it increased its offer [from the \$5.75 it proposed if the Meredith contract was not renegotiated] . . . [[I]t is not reasonably conceivable on the pled facts that Stewart caused Sequential to divert consideration.” While the plaintiffs cited allegations in their complaint pleading that Sequential lowered the offer price after negotiations with Stewart, those facts were contradicted by the proxy statement for the Sequential-*MSLO* transaction. The Court credited the proxy statement for the truth of the statements therein even at the motion to dismiss stage because plaintiffs relied heavily upon the proxy as the source of merger-related facts in the complaint and it was “integral to their claims.”

In refusing to credit the allegations in the Complaint to the extent they were contradicted by facts in the Proxy Statement, the *MSLO* opinion is one of a number of Delaware decisions over the last few years providing insight into how Delaware courts may view certain allegations or litigation positions. For instance, in a number of cases, Delaware courts have rejected what they deemed to be altered after-the-fact litigation testimony that was contradicted by emails or other written material created at the time of the events in question. See, e.g., *Pell v. Kill*, C.A. No. 12251-VCL (Del. Ch. May 19, 2016); *Fox v. CDX Holdings Inc.*, C.A. No. 8031-VCL (Del. Ch. July 28, 2015), *aff’d* 141 A.3d 1037 (Del. 2016), *reargument denied* (June 13, 2016); *In re El Paso Pipeline Partners, L.P. Derivative Litigation*, C.A. No. 7141-VCL (Del. Ch. Apr. 20, 2015). As the *Fox* Court observed, Delaware courts will not credit testimony “contrary to the contemporaneous evidence and [that] seem[s] crafted to parrot a legal standard.” Litigants will be hard-pressed to persuade a court of its arguments to the extent they are contradicted by contemporaneous evidence or SEC-filed materials on which the litigants themselves rely.

Not all disparate consideration to a controlling shareholder creates a material conflict with minority stockholders.

The premise of plaintiffs' complaint was that Stewart benefited herself to the detriment of minority stockholders through amounts Sequential agreed to pay to her through the "side deals." The Court found, however, that these side deals did not create a material conflict. With respect to most of the compensation, plaintiffs had failed to distinguish how Stewart's "side deals" with Sequential differed from her existing arrangements. As for the \$4 million in reimbursement for Stewart's expenses in negotiating her post-closing arrangements, the Court observed that this amounted to only \$0.07 per share for MSLO stockholders (as to which Stewart bore half the cost). In addition, Sequential had a proper interest in paying this amount in order to entice Stewart to continue an active role in the company. Indeed, the Court stated that it "could not reasonably conceive" of a situation where Stewart's "side deals" represented an inappropriate diversion of consideration from stockholders, especially since "[Stewart] herself was a stockholder who had by far the largest stake." Not only did the "side deals" not amount to a conflict, according to the Court, but Stewart's continued participation in the Company via these arrangements "enabled stockholders to realize premium value for their shares." As a result, Stewart's disparate consideration, *i.e.*, the side deals, did not create a material conflict with minority stockholders such that entire fairness review would be triggered, although the Court went on to examine whether the *MFW* criteria were satisfied in this situation assuming that Stewart had been in a conflict situation.

The *MFW* requirement that a controller transaction be conditioned on the dual stockholder protections of independent special committee and minority stockholder approval is triggered in the single-side transaction context only when the controlling stockholder first negotiates additional consideration.

MFW holds that in order to obtain business judgment rule review in the context of a transaction with a conflicted controller, the transaction must be conditioned "*ab initio*," *i.e.*, from the outset, on approval by an independent special committee of the board and a majority of minority stockholders. The Court explained the rationale for this requirement: "[T]he special committee must 'function in a manner which indicates that the controlling stockholder did not dictate the terms of the transaction and that the committee exercised real bargaining power at an arms-length.'" The *MFW* dual protections reflect the Delaware courts' heightened suspicion of transactions involving controller stockholders, whether one-sided or not, because controllers are in a unique position potentially to extract benefits at the expense of minority stockholders.

According to Vice Chancellor Slight, the timing of when these conditions need to be in place differs depending on the type of transaction in question. In particular, a controller who receives an offer from a third party lacks the same ability to set deal terms as when the controller is on both sides of the transaction: "the controller obviously has no control over the conditions the third party will impose on the process or approval of the transaction." As a result, according to the Court, the "get-go" event triggering the necessity of the *MFW* minority stockholder protections is when the

controller begins negotiating separate arrangements with the third party. Business judgment rule review will apply under the *MFV* framework so long as “the third party and the target have agreed to both procedural protections before she begins to negotiate separately with the third party for disparate or non-ratable consideration . . . when the potential conflict with the minority surfaces.” If the business judgment rule applies, the only available remaining option for plaintiffs is to challenge the transaction as waste, “a notoriously exacting standard” almost inconceivable to imagine being satisfied where minority stockholders approve the transaction on an informed basis.

Courts require factual allegations of undisclosed, material conflicts on the part of committee members or financial advisors in order for such conflicts to render the Committee not independent or ineffective.

The Court summarily rejected plaintiffs’ allegations that members of the Special Committee were beholden to Stewart as based on nothing more than conclusory assertions that the Committee members had prior business relationships with or traveled in the same circles as Stewart. The Court likewise rejected plaintiffs’ conclusory allegations that the Special Committee was ineffective because the Complaint failed to plead facts permitting an inference that the Committee was grossly negligent. The Court found that the Complaint did not meet this standard because, among other things, the Committee “met frequently over a period of months,” “rejected a proposal from Company A,” and convinced “Sequential to increase its final offer even though the troublesome. . . [Meredith] publishing agreement” never was successfully negotiated. Plaintiffs also cited the allegedly narrow scope of the Committee’s ability to hire legal and financial advisors, a contention contradicted by the proxy statement, which set forth the “Special Committee’s broad mandate to negotiate a transaction.”

The Court also rejected plaintiffs’ argument that the Special Committee was ineffective because its financial advisor was conflicted due to its pre-existing ties to a member of the full MSLO board – allegedly a “loyal friend of Stewart’s” – and to the second largest shareholder in Sequential. Referring to this argument as a “daisy chain of inferences,” the *MSLO* Court emphasized the so-called “loyal friend” was not a member of the Special Committee, which hired the financial advisor, and there were no allegations that the “loyal friend” interfered with the Special Committee’s work. Additionally, the financial advisor performed prior work not for Sequential but for a Sequential-related affiliate that was the second largest Sequential stockholder, as publicly disclosed in the proxy. The Court concluded that this “remote relationship, fully disclosed to MSLO stockholders” did not render the Special Committee ineffective by a conflicted financial advisor.

Plaintiffs failed to allege that the majority of the minority vote condition was ineffective, though they may have not advanced the proper argument.

The Court rejected plaintiffs’ argument that the majority of the minority vote condition was ineffective because it was established at an improperly late point in time. As discussed above, the Court found that MSLO and Sequential agreed to the majority of the minority vote condition prior to

