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New York Court of Appeals Adopts Delaware Standard in Evaluating Controlling Shareholder Going-Private Mergers

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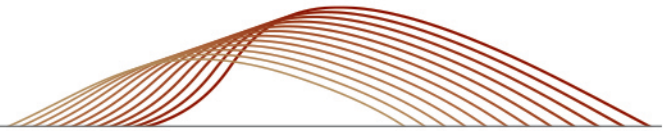
In *Matter of Kenneth Cole Prods., Inc., S'holder Litig.* ("*Cole*"),[1] the New York Court of Appeals held that, in reviewing challenges to going-private mergers proposed by controlling shareholders, New York courts should apply the deferential business judgment rule presumption, as long as six shareholder-protective conditions are met; if those measures are not met, the more stringent entire fairness standard of review would apply. In so holding, New York's highest court expressly adopted the standard of review and conditions recently adopted in the same context by the Delaware Supreme Court in *Kahn v. M&F Worldwide Corp.* ("*MFW*").[2]

Background

Over 30 years ago, in *Alpert v. 28 Williams St. Corp.* ("*Alpert*"),[3] the New York Court of Appeals held that the stringent entire fairness standard, requiring demonstration of the fairness of both price and process (or "fair dealing"), applied to a conflicted two-step merger. In that case, the Court explained that "when there is an inherent conflict of interest, the burden shifts to the interested directors or shareholders to prove good faith and the entire fairness of the merger."[4] The *Alpert* court specifically stated that it was not deciding whether the entire fairness standard would be the same for other types of mergers (including "going-private" mergers initiated by a majority or controlling shareholder).[5] It should also be noted that in *Alpert*, while the transaction at issue was ultimately found to be fair,[6] no independent special committee or majority of the minority shareholder vote condition was employed.[7]

In Delaware, prior to *MFW*, while the entire fairness standard generally was deemed to apply *ab initio* to controlling stockholder going-private mergers, there was the potential to achieve a burden shift through use of negotiation and approval by a properly functioning special committee of independent directors and/or a majority of the minority stockholders.[8] In such a burden shift, instead of the fiduciaries being required to prove fairness, plaintiffs would have to prove that the transaction was unfair.[9] In *MFW*, however, the Delaware Supreme Court outlined a path through which controlling stockholders might avoid the entire fairness review altogether and instead achieve the benefits of the more deferential business judgment rule presumption in going-private mergers in which the merger is conditioned up front on the approval of both an independent, adequately-empowered special committee that fulfills its duty of care, and the uncoerced vote of a majority of the minority stockholders.[10] Specifically, under the *MFW* analysis, business judgment rule deference would be available only if six minority-protecting conditions are met:



> (i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (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; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.[11]

The Decision

In *Cole*, the New York Court of Appeals reviewed a challenge to a going-private merger proposed by a shareholder alleged to control 89% of the voting power of the underlying corporation.[12] The majority shareholder's offer was conditioned from the outset on approval both by a special committee and by a majority vote of the minority shareholders.[13] The Court of Appeals confronted the primary issue of whether the going-private merger should be reviewed under the business judgment rule or the entire fairness standard.[14] The Court of Appeals held that New York courts should follow *MFW* and employ the business judgment standard of review provided the six shareholder-protective conditions quoted above are met.[15] Under this standard, a plaintiff first must allege at least a reasonably conceivable set of facts showing that some of the six conditions did not exist, and then to defeat summary judgment, must demonstrate a question of fact as to the establishment or efficacy of the enumerated conditions; if the plaintiff meets that burden, business judgment rule review may not be available and the entire fairness standard may be applied.[16]

The *Cole* court found that "the *MFW* standard properly considers the rights of minority shareholders – to obtain judicial review of transactions involving interested parties, and to proceed to trial where there is adequate proof that those interests may have affected the transaction – and balances them against the interests of directors and controlling shareholders in avoiding frivolous litigation and protecting independently-made business decisions from unwarranted judicial interference."[17] The court applied the standard to the merger at issue and concluded that business judgment rule review should apply.[18] Because plaintiff failed to allege fraud or bad faith sufficient to overcome the business judgment rule presumption, the Court found it should defer to the determination of the special committee and the board of directors in recommending and approving the merger, and affirmed dismissal of the case.[19]

Takeaway

The *Cole* decision importantly aligns New York and Delaware law and provides a roadmap for controlling shareholders of New York corporations to seek to take advantage of more deferential business judgment rule review of going-private mergers. It will be interesting to watch the continued evolution of this area of merger review in other states, as well as how New York courts may apply or interpret *Cole* in other contexts, including review of two-step mergers more reminiscent of that confronted in *Alpert*.

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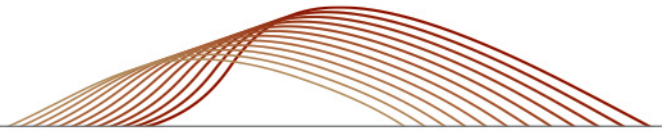

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings New York lawyers:

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[1] *2016 NY Slip Op. 03545 (May 5, 2016).*

[2] *88 A.3d 635 (Del. 2014). A discussion of the Court of Chancery's initial decision in MFW can be found here.*

[3] *63 N.Y.2d 557 (1984).*

[4] *Id. at 570.*

[5] *Id. at 567 n.3.*

[6] *Id. at 573-74.*

[7] *2016 NY Slip Op. 03545, at *4.*

[8] *88 A.3d at 642-43.*

[9] *Id.*

[10] *Id. at 645.*

[11] *Id.*

[12] *2016 NY Slip Op. 03545, at *1.*

[13] *Id.*

[14] *Id. at *3.*

[15] *Id. at *3-6.*

[16] *Id. at *6-7.*

[17] *Id. at *6.*

[18] *Id. at *7-8.*

[19] *Id. at *8.*