

COURT OF CHANCERY EXTENDS M&F WORLDWIDE FRAMEWORK TO CONTROLLER/THIRD PARTY TRANSACTIONS

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On August 18, 2017, the Delaware Court of Chancery issued a decision dismissing *In re Martha Stewart Living Omnimedia, Inc. Stockholder Litigation* (“MSLO”).¹ At first glance, the decision reiterates the holdings of previous decisions applying the business judgment rule to “one-side controller transactions,” *i.e.*, transactions negotiated between controlling stockholders and third parties, which focus on the degree to which the controller bargains for some form of differential consideration.² MSLO, however, fills an important doctrinal gap: what steps can transaction planners take to ensure business judgment review of a one-side controller transaction even if the controller does bargain for differential consideration?

In those situations, MSLO instructs that

business judgment review is invoked by the pair of procedural protections familiar from *Kahn v. M&F Worldwide*³—namely, an independent special committee and approval of a majority of the unaffiliated stockholders—implemented before the controlling stockholder and the acquiror “begin to negotiate the controller’s side deals.”

In so holding, the Court of Chancery made the sensible decision that if the same pair of procedural protections is sufficient to replicate arm’s-length bargaining between the controller and the corporation in a squeeze-out merger, then it should also be sufficient to replicate arm’s-length bargaining between the controller and the corporation in the context of a sale to a third party.

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Background Facts

Martha Stewart Living Omnimedia, Inc. was the media and merchandising Company that promoted and sold Martha Stewart-branded content and products. Stewart was “indisputably MSLO’s controlling stockholder.”⁴ In addition to her controlling stake, Stewart had employment and intellectual property licensing contracts with MSLO by which Stewart received approximately \$3.5 million a year, along with significant bonuses, and MSLO received the right to use her name and likeness.⁵

In the summer of 2014, a peer company (“Company A”) advised Stewart that it wanted to explore a strategic transaction with MSLO. Stewart informed MSLO’s Board of the expression of interest, and the companies entered into a confidentiality agreement. In discussing the expression of interest, the Board determined that it was appropriate to form a special committee “given Stewart’s control position and the uncertainty regarding what her arrangements would be in connection with a potential transaction.”⁶ The Board gave the special committee its “full and

exclusive authority” to explore and negotiate a potential transaction with Company A and to consider alternative transactions.⁷

While the negotiations with Company A were ongoing, Sequential Brands Group, Inc. indicated interest in a potential transaction. It was clear early in negotiations with Company A and Sequential that both were focused on extending the terms of Stewart’s contracts. After all, what would the Company be without her?

After receiving an initial offer from Sequential (at \$4.50 a share, MSLO’s trading price at the time), MSLO announced favorable financial results, and its stock price increased more than 35%, to \$6.45. Though Company A and Stewart had reached agreement on her contracts, and MSLO and Company A agreed to an exclusivity period, Company A would not increase its offer above \$4.90 per share. The Special Committee rejected the offer, and searched for other buyers.

Sequential was an obvious choice, and it made a revised offer of \$6.20 per share. The Special Committee met and determined that MSLO’s ne-

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gotiations with Sequential should proceed further before Stewart's negotiations with Sequential started. Sequential then made a revised proposal, contingent upon the approval of a majority of MSLO's unaffiliated stockholders.

Sequential also reiterated the importance of negotiating with Stewart as to her contracts. The Special Committee authorized Stewart to negotiate with Sequential in her personal capacity concurrently with the Special Committee's merger negotiations, subject to the Special Committee's right to review the results of those negotiations before recommending the deal to the Board.

Sequential submitted an improved proposal weeks later. After additional deliberation, and receiving a fairness opinion from its financial advisor, the Board accepted Sequential's offer of \$6.15 per share. Stewart agreed to new contracts with MSLO that largely tracked her existing relationship, save for Stewart receiving a percentage of licensing revenue beyond certain benchmarks and facing greater restrictions on using her name in new businesses if her employment terminated. Sequential also had agreed to similar expense reimbursement provisions, and would pay up to \$4 million of Stewart's fees she incurred in negotiating the post-closing arrangements.

MSLO stockholders overwhelmingly approved the merger, including approximately 99% of the unaffiliated stockholders.

The Court of Chancery's Ruling

The plaintiffs asserted that Stewart, as MSLO's controlling stockholder, breached her fiduciary duties by competing with MSLO's common stockholders for merger consideration through her supposedly lucrative "side-deals" with Se-

quential, and that Sequential aided and abetted those breaches. The Court separately analyzed (1) whether Stewart engaged in a conflicted transaction at all, applying existing case law, and alternatively, (2) whether the "dual procedural protections of an independent, disinterested and properly-empowered special committee and a non-waivable, fully-informed and uncoerced vote of a majority of the minority stockholders" invoked the business judgment rule as the transactional standard of review.

Under existing case law, the transactional standard of review was the business judgment rule because Stewart did not extract sufficient differential consideration to make the merger a conflict transaction: because Stewart did not stand on both sides of the deal, the Court examined whether she had exploited her position "to extract 'different consideration or derive some unique benefit from the transaction not shared with common stockholders.'" ⁸ The plaintiffs focused on the contracts Stewart negotiated with Sequential, arguing that she diverted merger consideration from the minority stockholders to herself. The Court disagreed, even at the pleadings stage, for three reasons.

First, Sequential's offer *increased* after it had substantially completed its negotiations with Stewart. In the Court's view, it was therefore "not reasonably conceivable . . . that Stewart caused Sequential to divert consideration from minority stockholders into its side deals with Stewart."⁹ Second, Stewart was so inherently valuable to the company that Sequential had "insisted upon and initiated the negotiations with Stewart regarding side deals in order to ensure that Martha Stewart would remain meaningfully involved with the Martha Stewart brand Sequential was

acquiring.”¹⁰ And third, plaintiff did not convince the Court that Stewart’s post-merger contracts with Sequential were better than her pre-merger contracts with MSLO “in any meaningful way that would support the inference that Stewart was extracting consideration from Sequential that otherwise would have gone to the MSLO shareholders.”¹¹ In short, because Sequential was acquiring the Stewart brand, “[i]t was entirely proper for Sequential to pay, and for Stewart to accept, extra consideration” to secure Stewart’s “time, energy and talent.”¹²

Because the parties employed the *M&F Worldwide* procedural protections before Stewart bargained on her own behalf, the proper transactional standard of review was the business judgment rule: Stewart argued that the deal was structured in a manner that provided MSLO’s minority stockholders “with the dual procedural protections of an independent, disinterested and properly-empowered special committee and a non-waivable, fully-informed and uncoerced vote of a majority of the minority stockholders.”¹³ Stewart argued that because the business judgment rule would apply if she stood on both sides of the transaction,¹⁴ it must also apply where, as here, she arguably did not.

The Court recognized, however, that the existing “disparate consideration” decisions Stewart relied upon did not answer the timing question: “[a]t what point must the parties to a potentially conflicted third-party transaction involving a controlling stockholder agree to the dual procedural protections?”¹⁵ Both *Hammons* and *SEPTA* were decided at summary judgment, and both preceded the Supreme Court’s emphasis, in *M&F Worldwide*, “on strict compliance, including *ab initio* timing.”¹⁶ As a result, Vice Chancellor

Slights described *Hammons* and *SEPTA* as “two of several waypoints on the long road leading to *M&F Worldwide*,” and not as “controlling authority” for deciding the case.¹⁷

In controlling stockholder squeeze-outs such as *M&F Worldwide*, the controlling stockholder controls the timing and its initial offer is the starting line from which the required procedural protections should run. But when is *ab initio* for purposes of a “one-sided controller transaction” like in *MSLO*, “where an unaffiliated third party initiates the process with its offer, the controller obviously has no control over the conditions the third party will impose on the process or approval of the transaction”?¹⁸

Vice Chancellor Slights concluded sensibly that the procedural protections should be implemented before the controller “begins to negotiate separately with the third party for disparate or non-ratable consideration.”¹⁹ That is when the controller’s interest begins to potentially conflict with the minority. If the size of the pie is fixed at that point, any consideration the controller receives would come at the expense of the minority. So long as the dual procedural protections are implemented before those negotiations begin, then all involved are aware that the special committee, and ultimately the minority stockholders, have the final say on whether the deal will be approved.

Having answered the key doctrinal question, the Court made quick work of the plaintiff’s arguments regarding the independence and effectiveness of the procedural protections employed by MSLO. Interestingly, the Court stated in some cases “the minority stockholders are asked to approve both the merger consideration, and implic-

itly, a variety of potentially complex contractual arrangements between the controlling stockholders and the third-party, the value of which may be difficult to determine.”²⁰ With citation to Vice Chancellor Glasscock’s recent decision in *Sciabacucchi v. Liberty Broadband Corp.*,²¹ which denied a motion to dismiss on the basis that it was reasonably conceivable the stockholder vote was structurally coercive, the Court noted it is an open question of “how much a board can permissibly pack into a stockholder vote when seeking to proffer the vote as” as an independent, informed approval.²²

As a result of the above analysis, the Court granted the defendants’ motions to dismiss, including as to Sequential because the plaintiffs failed to establish the predicate breach of fiduciary duty to establish an aiding and abetting claim.

Lessons and Implications

As a factual matter, *MSLO* can be seen as having limited value. The decision could have been written narrowly to only address situations involving controlling stockholders who also are indispensable to the corporation and who possess significant existing contractual relationships.

But the Court crafted a decision with more far-reaching doctrinal implications. It establishes *M&F Worldwide*, rather than *Hammons* or *SEPTA*, as the key precedent in evaluating the use of procedural protections for transactions involving controlling stockholders. The decision also supplies guidance for transaction planners in this context about timing.

Someone, most likely counsel, must ensure the negotiations do not proceed too quickly, without

procedural protections in place. It will be natural for an acquiror to want to firm up the controller’s support, but if parties are not careful about their early conversations, they may unwittingly move over the line into what will be seen after the fact as separate negotiations for the controller. At that point, it may be too late to implement the dual procedural protections of *M&F Worldwide*.

Counsel should prepare acquirors and controlling stockholders to discuss only the broad terms of the deal, and not additional or separate consideration for the controller. Those conversations with the controller should only occur after a special committee is formed and functioning, and the parties agree to condition the deal on a majority of the minority vote. This is important for acquirors as well because they, like Sequential, are likely to be alleged to be an aider and abettor. Working with the target and controller to employ the dual procedural protections will ensure a case challenging the deal is dismissed at the pleadings stage.

Finally, the Court’s rulings are helpful in understanding when a conflict actually arises. If there are no separate negotiations, agreements, or consideration, then there is likely no conflict to address as the interests of the controller and minority stockholders are aligned. As to “side deals” like those Stewart agreed to, *MSLO* is helpful in establishing that not all consideration received by a controlling stockholder creates a material conflict with the minority stockholders. The more those “side deals” track existing agreements and so cannot be viewed as a funneling of merger consideration to the controlling stockholder, the more likely they are to be found as proper and not giving rise to a conflict.

Conclusion

MSLO provides controlling stockholders with a clear path to the deferential business judgment standard of review in a one-sided controller transaction. As with a controller squeeze-out of the minority, the controller must effectively disable its control at both the board and stockholder levels, and agree to vest control of the transaction on the target side in an independent special committee of the board, and the unaffiliated stockholders. From a timing perspective, this structure should be in place before the controller begins negotiating with the acquiror for disparate or non-ratable consideration.

Provided the protections are employed by that time and are effective and non-coercive in practice, the parties to the transaction can expect to succeed on a motion to dismiss.

ENDNOTES:

¹2017 WL 3568089 (Del. Ch. Aug. 18, 2017).

²*See Se. Pa. Transp. Auth. v. Volgenau*, 2013 WL 4009193 (Del. Ch.), *aff'd*, 91 A.3d 562 (Del. 2014); *In re John Q. Hammons Hotels, Inc. S'holder Litig.*, 2009 WL 3165613 (Del. Ch. Oct. 2, 2009).

³88 A.3d 635 (Del. 2014).

⁴*MSLO*, 2017 WL 3568089 at *4.

⁵*Id.* at *5.

⁶*Id.*

⁷*Id.*

⁸*Id.* at *11 (quoting *In re Crimson Exploration Inc. S'holder Litig.*, 2014 WL 5449419, at *8 (Del. Ch. Oct. 24, 2014)).

⁹*MSLO*, 2017 WL 3568089 at *12.

¹⁰*Id.*

¹¹*Id.*

¹²*Id.* at *13.

¹³*Id.* at *14.

¹⁴*See Kahn v. M&F Worldwide, Inc.*, 88 A.3d 635 (Del. 2014).

¹⁵*MSLO*, 2017 WL 3568089 at *14.

¹⁶*Id.* at *16.

¹⁷*Id.* at *17.

¹⁸*Id.* at *18.

¹⁹*Id.*

²⁰*Id.* at *24 n. 117.

²¹2017 WL 2352152 (Del. Ch. May 31, 2017).

²²*Id.* at *24 n. 117.

TABCORP/TATTS DECISION: KEY LESSONS AND THE FUTURE OF THE COMPETITION TRIBUNAL

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The Australian Competition Tribunal (“Tribunal”) has authorized the proposed acquisition of Tatts Group Limited (“Tatts”) by Tabcorp Holdings Limited (“Tabcorp”) in a decision which strongly suggests that the landscape for merger authorizations under the Competition and Consumer Act 2010 (Cth) (“CCA”) is changing. The success of Tabcorp’s application, and the unique nature of these proceedings when compared with the previous two applications that were heard and decided by the Tribunal, was delivered by a statutory process which provides the merger parties with a distinct advantage over any potential objectors to the transaction. This advantage does