

INSIGHTS

New York Adopts Delaware Standard for Going-Private Transactions

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On May 5, 2016, the New York Court of Appeals affirmed the dismissal of a shareholder class action and formally adopted the standard of review for going-private transactions articulated by the Delaware Supreme Court in *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) ("*MFW*"). The decision in *Matter of Kenneth Cole Productions, Inc., Shareholder Litigation*, No. 54 (N.Y. May 5, 2016), confirms that the deferential business judgment standard of review will apply to going-private transactions under New York law if certain shareholder-protective conditions are present.

Case Summary

This lawsuit arose from a going-private merger between Kenneth Cole Productions, Inc. ("KCP"), a New York corporation, and its founder and controlling shareholder, Kenneth Cole. Slip Op. at 2. Cole sat on KCP's five-member board of directors and held roughly 46% of KCP's Class A stock, all of its Class B stock, and approximately 89% of shareholder voting power. *Id.* In February 2012, he announced to the board his intention to purchase all outstanding Class A shares and take KCP private. *Id.* at 2-3. The board created a special committee consisting of the other four board members to consider Cole's proposal. *Id.* at 3. On February 23, 2012, Cole submitted an offer of \$15.00 per share conditioned on approval by (i) the special committee, and (ii) a majority of the KCP's minority shareholders. *Id.* He also stated that he would not seek – or approve of – any other type of merger, and that his relationship with KCP would not be adversely affected if the merger did not go forward. *Id.*

After retaining independent counsel and advisors, the special committee engaged in negotiations with Cole and sought an increased offer. *Id.* Following months of negotiations, the special committee accepted Cole's offer of \$15.25 per share and recommended it to the minority shareholders, who ultimately approved it by a vote of 99.8%. *Id.* at 4.

Prior to the board's approval, several shareholders filed class action lawsuits (which were eventually consolidated) seeking to enjoin the merger and alleging, *inter alia*, that Cole and the board had breached their fiduciary duties. *Id.* 3-4. The Supreme Court granted defendants' motion to dismiss, holding that plaintiffs did not demonstrate that the special committee members lacked independence or that Cole or the board had breached their fiduciary duties. *Id.* at 4-5. The Appellate Division affirmed. *Id.*

On appeal, the New York Court of Appeals addressed the following question: "what standard should be applied by courts reviewing a going-private merger that is subject from the outset to approval by both a special committee of independent directors and a majority of the minority shareholders." *Id.* at 6. Following the Delaware Supreme Court's decision in *MFW*, the Court

held that the business judgment rule should apply if certain conditions are met; otherwise, the much more rigorous entire fairness standard should apply. *Id.*

The Court's Reasoning

The Court of Appeals began by recognizing the general principle under New York law that courts should avoid interfering with the internal management of corporations. *Id.* at 6. Thus, New York courts, like Delaware courts, long have applied the business judgment rule, pursuant to which courts generally defer to the unbiased, good faith decisions of corporate officers and directors. *Id.* However, the Court recognized that freeze-out mergers, which usually implicate divided or compromised loyalties, call into question the application of that rule. *Id.* at 7. In its seminal decision in *Alpert v. 28 Williams St. Corp.*, 63 N.Y.2d 557 (1984), the Court held that the entire fairness standard applied to a two-step merger involving common directors or majority ownership between the transaction parties. *Id.* at 8 (stating that where such a conflict of interest exists, the burden shifts to the interested directors or shareholders to prove good faith and entire fairness – *i.e.*, fair process and fair price).

Turning to the *MFW* framework, the Court of Appeals recognized that this case presented the exact same question addressed by the Delaware Supreme Court in *MFW* – specifically, what standard applies to a going-private merger conditioned from the start on approval by **both** an independent committee and a majority-of-the-minority vote. *Id.* at 10 (citing *MFW*, 88 A.3d at 639). The Court noted that the Delaware Supreme Court had recognized that allowing for the application of the business judgment standard actually incentivizes majority shareholders to protect the minority in a freeze-out merger. *Id.* at 10-11 (citing *MFW*, 88 A.3d at 643). Indeed, by incorporating the double protections of an independent special committee and an informed majority-of-the-minority vote, a going-private merger acquires the characteristics of a third-party arm's length merger. *Id.* (citing *MFW*, 88 A.3d at 643). Moreover, the standard is “consistent with the tradition of courts deferring to informed decisions by impartial directors, especially when approved of by disinterested and informed stockholders.” *Id.* at 11 (citing *MFW*, 88 A.3d at 644).

Based on this reasoning, the Court adopted the *MFW* standard: the business judgment standard, rather than the entire fairness standard, “will be applied if and only if: (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.” *Id.* at 11-12 (quoting *MFW*, 88 A.3d at 645) (emphasis in original). Here, plaintiffs failed to show that any of these conditions were missing. *Id.* at 16. As a result, the lower court properly deferred to the special committee and board pursuant to the business judgment standard and dismissed the complaint. *Id.* at 16-17.

Takeaways

In *Kenneth Cole*, the New York Court of Appeals confirmed that New York law provides a path to business judgment review for going-private transactions provided they are conditioned at the outset on approval by a special committee of independent directors and a fully-informed majority-of-the-minority vote. In so holding, the Court reaffirmed New York's longstanding recognition that courts generally should not interfere with unbiased, good-faith management decisions.

By adopting the standard articulated in *MFW*, the Court also confirmed that, in the absence of controlling or contrary New York precedent, New York courts often will look to Delaware law as persuasive authority. Thus, in many instances, the well-developed body of Delaware corporate law may lend some predictability to decisions applying New York law.

In particular, *Kenneth Cole* suggests that New York courts will turn to Delaware decisions with respect to the application of the *MFW* standard. These Delaware decisions demonstrate that, in certain circumstances, the application of *MFW* may yield the dismissal of shareholder actions at the pleading stage, prior to expensive plenary discovery. However, these Delaware decisions also demonstrate that the *MFW* standard provides no guarantee of business judgment review and that, absent scrupulous observance of the *MFW* framework, shareholder complaints still may survive a motion to dismiss.