Client Alert

pillsbury

Corporate & Securities

Corporate & Securities – Technology | Litigation

October 20, 2016

Delaware Court of Chancery Applies Business Judgment Rule in a Controlling Stockholder Going-Private Transaction Despite Third Party's Nearly 30% Higher Offer

By Jonathan J. Russo, Justin D. Hovey, Nathaniel M. Cartmell III, Bruce A. Ericson and Naresh C. Lall

In Books-A-Million, *the Delaware Court of Chancery dismissed a complaint challenging a controlling stockholder going-private transaction, holding that the transaction satisfied the standards of* M&F Worldwide *despite a third party's 30% higher offer. The Court found no reasonable inference that the Special Committee acted in bad faith and compromised its independence because, among other things, (i) the Special Committee solicited third-party offers to better assess the value of the Company and the attractiveness of the controlling stockholder's offer, and (ii) the merger consideration offered by the controlling stockholder for the minority of the Company's shares fell within a rational range of a discount when compared to the third-party offer, which sought control.*

Introduction

In *In re Books-A-Million, Inc. Stockholders Litigation*, C.A. No. 11343-VCL, 2016 WL 5874974 (Del. Ch. Oct. 10, 2016), the Delaware Court of Chancery applied the principles set forth in *Kahn v. M&F Worldwide Corp*, 88 A.3d 635 (Del. 2014) and determined that the "business judgment" standard of review should be applied to a controlling stockholder squeeze-out merger. Recognizing that pleading subjective bad faith could theoretically be a viable means of rebutting the independence of the Special Committee (needed to obtain business judgment treatment under *M&F Worldwide*), the Court (i) reviewed the obligations of a special committee in a controlling stockholder going-private transaction in which the controlling stockholder has no interest in selling its shares and a third party offers a higher price for the entire company as opposed to just the minority shares and (ii) determined that the Special Committee in this instance acted in good faith. In doing so, the Court noted that the Special Committee, despite the controlling stockholder's position that it was only a buyer, not a seller, solicited third-party offers to compare against the controlling stockholder's bid and negotiated a higher price for the minority shares.

Background

Books-A-Million, Inc. ("BAM" or the "Company"), a Delaware corporation engaged in the retail book business, was founded in 1917 by Clyde W. Anderson and is still controlled by his descendants (the "Anderson Family"). Before the proposed Merger, the Anderson Family controlled approximately 57.6 percent of the Company's outstanding voting power. Between 2012 and 2014, the Anderson Family made several proposals to buy out the minority, and a third-party ("Party Y") made several proposals either to buy out the Andersons or all the stockholders; nothing came of these proposals. In January 2015, the BAM board of directors (the "Board") received an unsolicited proposal from the Anderson Family to buy out the minority for $2.75 per share in a negotiated transaction. The price represented a 65 percent premium over the average closing price for BAM's stock for the prior 90 trading days. At the time of the proposal, the Board had five members, including two members of the Anderson Family. The proposal stated that the Anderson Family expected the Board to establish a Special Committee of independent directors and conditioned the transaction on the approval of the Special Committee and a non-waivable majority of the minority stockholder vote. The proposal further stated that the Anderson Family was only interested in acquiring the shares it did not already own and was not interested in selling its shares to a third party. The Board formed a Special Committee, which selected financial and legal advisors, evaluated alternative transaction structures, and solicited offers from three other parties (Parties X, Y, and Z) that had previously expressed an interest in the Company. Party Y submitted an indication of interest to acquire all of the Company's shares for $4.21 per share subject to due diligence, financing and other conditions. In response, the Anderson Family said it would only buy and not sell, and Party Y said it was not interested in less than control.

After additional inquiries, the Committee decided the best course was to negotiate with the Anderson Family. After several offers and counteroffers, the Anderson Family increased its offer to $3.25 a share. Meanwhile, Party Y reiterated its interest at $4.21 per share, but only if it could acquire 100 percent of the shares. Following presentations to the Committee (including a fairness opinion and a solvency opinion), the Committee approved the Merger with the Anderson Family at $3.25 per share. Members of the Anderson Family and senior management entered into voting agreements in which they committed to vote all of their shares in favor of the Merger. Holders of approximately 66.3 percent of the shares not affiliated with the Anderson Family or senior management voted to approve the Merger.

Challenging the squeeze-out merger, the plaintiffs argued that the defendants breached their fiduciary duties and the Board's decision should not be reviewed under the "business judgment" rule because (i) one of the Board members, who initially was a member of the Special Committee but resigned, was not independent and tainted the independence of the Committee by sitting in on the fairness opinion presentation to the Committee and (ii) the members of the Special Committee approved the Merger in bad faith, thereby displaying a lack of independence in fact, since the directors did not accept Party Y's substantially superior offer. The Court disagreed, holding that the allegations did not support a reasonable inference that any of the *M&F Worldwide* conditions were not met or that the Merger constituted waste.

The Court's Analysis

The Court noted that the Anderson Family offer from the outset included the dual conditions of *M&F Worldwide* – approval by a special committee plus a non-waivable approval of a majority of the minority. Thus, the business judgment rule would apply unless plaintiffs' complaint created a reasonable inference that the transaction did not in fact satisfy *M&F Worldwide*. The Court reviewed at great length the independence of the Special Committee. The Court commended the Board member who resigned from the Committee at an early stage after self-identifying social and civic relationships with the Anderson Family. The Court noted that even though the Board member subsequently attended the fairness opinion presentation so as to avoid the need of the Committee's financial advisor to make multiple presentations, he was excused before deliberations began, and the Committee deliberated and ultimately voted to accept the Anderson Family offer without the Board member present. Notably, however, the Court cautioned that under different circumstances the presence of a director whose independence was compromised might be problematic.

The Court dismissed plaintiffs' main contention that the independent directors acted in bad faith by recommending the Anderson Family offer and elevating the interests of the Anderson Family over those of the minority stockholders. The plaintiffs argued that it is not rational for a director to accept a lower-priced offer when a comparable higher priced offer is available and the directors must have had some ulterior motive for not pursuing Party Y's higher offer. While the Court noted that subjective bad faith is theoretically a viable means of attacking the *M&F Worldwide* framework's requirement that the Special Committee be "independent," the Court analyzed the issue in the context of the circumstances facing the Committee. The Court found that the Committee's actions of (i) exploring third-party offers to assess the value of the Company and the attractiveness of the Anderson Family's offer and (ii) assessing whether the Anderson Family's bid was so low that it should be rejected outright, supported an inference of good faith. The Court did not consider the two offers "comparable": Party Y's offer sought to acquire control of the Company whereas the Anderson Family, which already owned "control" of the Company, merely sought to purchase the minority shares. The Court noted that the Anderson Family's offer fell within a rational range of discounts and premiums, and that under the *M&F Worldwide* framework the transaction would not close unless a majority of minority stockholders approved it. Moreover, the Court recognized that (i) given the Anderson Family's controlling stake, the Special Committee could not force the Anderson Family to accept Party Y's offer, and (ii) because the Anderson Family offer was at a substantial premium to market and conditioned on the *M&F Worldwide* framework, it was not seeking to exploit the minority stockholders, and therefore as a fiduciary matter, the Committee was not in a position to take action against the Anderson Family to facilitate Party Y's offer.

Key Takeaways and Practice Points

- **It is Not Bad Faith to Decline a Higher Offer.** Leaning heavily on *Mendel v. Carroll*, 651 A.2d 297 (Del. Ch. 1994), Vice Chancellor Laster rejected allegations that the Special Committee acted in bad faith by not forcing the Anderson Family to accept the higher third-party offer. Vice Chancellor Laster reasoned that merely comparing the dollar value of the price of the Anderson Family offer and the third-party offer was insufficient to raise an inference of bad faith or waste, because Party Y's offer was necessarily higher due to the control premium associated with acquiring the shares of the Anderson Family, whereas the Anderson Family's offer reflected the fact that it already had control. In reviewing fundamentally different offers, Boards should consider whether the bargained-for consideration falls within a rational range of discounts and premiums. If the amount of a minority discount is extreme, plaintiffs may be successful in arguing that there is a reasonable inference that the independent directors acted in bad faith and sought to serve the interests of the controlling stockholder. In *BAM*, 30 percent was not extreme given the circumstances.

- **Reliance on Appraisal Rights.** The Court also noted that the existence of appraisal rights acted as a further check on a controlling stockholder transaction. The Court noted that the Special Committee could rely on the fact that minority stockholders who felt aggrieved over price could protect themselves through the appraisal process, which in valuing the shares would not give effect to either a minority discount or control premium. Not surprisingly, the Anderson Family attempted to condition its obligation to close on an appraisal rights provision of more than 5 percent of the stockholders. The Special Committee pushed back on the appraisal rights condition, and the parties ultimately agreed to increase the appraisal rights condition to 10 percent or more. The Court commented favorably on such negotiation and on the ultimate reality that not only must a majority of the minority shares approve the merger, but, given the Anderson Family's appraisal rights closing condition, that a minority of the minority could, if dissatisfied with the merger price, affect the outcome of the transaction.

- **The Importance of Upfront Dual Deal Conditions.** The *BAM* case demonstrates yet again the advantage for a going-private proposal by a controlling stockholder in requiring at the outset both the approval of a sufficiently independent and adequately empowered special committee and an un-coerced, informed majority-of-the-minority. A controlling stockholder transaction which satisfies these conditions and the other elements of *M&F Worldwide* will be reviewed under the "business judgment" rule, unless the plaintiffs can plead sufficient facts to call into question whether those elements have been satisfied or the transaction constitutes waste.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

Jonathan J. Russo (bio)
New York
+1.212.858.1528
jonathan.russo@pillsburylaw.com

Justin D. Hovey (bio)
San Francisco
+1.415.983.6117
justin.hovey@pillsburylaw.com

Nathaniel M. Cartmell III (bio)
San Francisco
+1.415.983.1570
nathaniel.cartmell@pillsburylaw.com

Bruce A. Ericson (bio)
San Francisco
+1.415.983.1560
bruce.ericson@pillsburylaw.com

Naresh C. Lall (bio)
New York
+1.212.858.1233
naresh.lall@pillsburylaw.com