Securities Litigation Alert

May 11, 2016

If you only read one thing…

- New York is now in accord with Delaware in using the business judgment rule — rather than the entire fairness doctrine — when considering going-private transactions, but only if certain minority shareholder protections are in place.
- The decision provides a checklist of six specific conditions that must be met for the corporation and its directors to obtain the benefit of the business judgment rule.

New York High Court Adopts Business Judgment Rule for Going-Private Transactions When Certain Minority Shareholder Protections Are In Place

Last week the New York Court of Appeals rendered an important decision involving going-private transactions in which a controlling shareholder offers to buy out the public shares. The high court announced that "New York courts should apply the business judgment rule as long as certain shareholder-protective conditions are present; if those measures are not present, the entire fairness standard should be applied."[1]

Background of Kenneth Cole Productions Shareholder Litigation

The case involved Kenneth Cole Productions (*KCP*), a public New York corporation well-known as the designer and marketer of shoes, apparel and accessories. In February 2012, Kenneth Cole, founder of the company in 1982 and chairman of the board, proposed a going-private merger by which a company he indirectly owned would purchase all of the shares of the corporation that he and his family did not already own. At that time, he owned approximately 46 percent of the corporation's Class A shares and all of the Class B shares. Due to the super-voting powers of the Class B shares, Cole held approximately 89 percent of the voting power of *KCP*.

Cole proposed a price of $15.00 per share, which was a premium over the stock's most recent selling price. His proposal was subject to two conditions: approval by a special committee of the board, and approval by a majority of the minority shareholders. He told the board that if either approval was not obtained, he would withdraw the proposal, and that his relationship with *KCP* would not be affected. He

[1] *In the matter of Kenneth Cole Productions, Inc., Shareholder Litigation*, No. 54 (N.Y. Ct. App., May 5, 2016), 2016 NY Slip Op 03545, at 1-2.

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also informed the board that he was interested only in buying the shares he did not already own, and was unwilling to sell his own shares to a third-party buyer. He then left the board meeting.

The board created a special committee to negotiate with Cole, composed of four long-standing independent directors not employed by *KCP*. Two directors had been elected by the Class A shareholders and two had been elected by Class A and Class B shareholders, which meant that they effectively had been elected by Cole. The committee retained counsel and a financial advisor, and negotiated with Cole over the next several months. Cole increased his offer to $15.50 and then $16.00 per share, but then reduced it back to $15.00, citing news of problems in the company and the economy. The committee continued to negotiate with Cole, who eventually increased his offer to $15.25. The committee approved the transaction at $15.25 in June 2012. *KCP* then filed a Preliminary Proxy Statement with the Securities and Exchange Commission, which provided several rounds of comments. The minority shareholders voted in September 2012, with 99.8 percent voting to approve.

Several plaintiffs filed lawsuits against the company and the directors for alleged breaches of fiduciary duty within five days of the announcement of the proposal — indeed, before the directors had taken any substantive action in response to Cole's proposal. Plaintiffs alleged that the directors on the special committee had breached their fiduciary duties to the minority shareholders for failure to obtain a better price. They also alleged that two of the directors were not independent and were controlled by Cole, although these directors did not have a financial interest in the stock purchase other than as owners of Class A shares.

The New York Supreme Court (the trial court) granted defendants' motions to dismiss the complaints. The court said that "plaintiffs point to no authority for the assertion that a director lacks independence solely on the ground that he or she is elected by a controlling shareholder. The complaint also fails to set forth facts demonstrating a lack of independence on the part of any of the other individual defendants."[2] Plaintiffs also alleged that the directors should have obtained third-party bids, but the trial court noted that "the complaint itself acknowledges Cole's consistent assertion, on several occasions, that he would reject any such offers. Moreover, it is undisputed that no such offers were received, despite the publicity surrounding Cole's attempt to repurchase the stock." The trial court therefore concluded that the complaint did not adequately allege facts that would "demonstrate that the decision not to seek other bids constituted a breach of fiduciary duty."

The trial court also rejected the contention that the directors had breached their fiduciary duty for failure to obtain a better price, stating that "plaintiffs acknowledge that the special committee negotiated with Cole over a period of months and obtained an increase in the price he would pay, from $15 to $15.25, where the original price represented a premium over the stock's most recent selling price." The trial court said that "absent a showing of specific unfair conduct by the special committee, the Court will not second

[2] *In re Kenneth Cole Productions, Inc. Shareholder Litigation*, No. 650571/2012 (N.Y. Sup. Ct., 2013), 2013 NY Slip Op 32114(U), 2013 N.Y. Misc. LEXIS 4026, 2013 WL 476369, at 6.

guess the committee's business decisions in negotiating the terms of a transaction. Plaintiffs have not even alleged facts that, if true, would give the Court a legitimate basis for judicial inquiry. Absent that, the Court is bound by the business judgment rule." Accordingly, the trial court dismissed the case.

Plaintiffs Argue for "Entire Fairness" Doctrine at the Appellate Division

On appeal to the New York Supreme Court, Appellate Division, plaintiffs argued that the *KCP* transaction should be governed by the "entire fairness" doctrine, under which the burden of proof would be on the defendants to establish that the transaction was fair to the minority shareholders. Plaintiffs relied on *Alpert v. 28 Williams St. Corp.,* a 1984 decision by the New York Court of Appeals involving a corporate freeze-out in a two-step merger.[3] In *Alpert*, defendants first bought a controlling interest in a corporation that owned an office building on Madison Avenue in Manhattan. The defendants then arranged for the corporation to merge into another corporation also controlled by them, conditioned on the "freeze-out" of the minority shareholders through the forced cancellation of their shares at a non-negotiated price. In *Alpert*, the Court of Appeals held that such a transaction required proof of the "entire fairness" of the transaction to the minority shareholders. "Entire fairness" required proof that "the transaction viewed as a whole is fair to the minority shareholders," and that the transaction was "justified by an independent corporate business purpose." In the context of a freeze-out merger, the Court of Appeals said that fairness required both "a course of fair dealing toward minority holders" (i.e., a fair process) and a fair price for the minority's stock.

In the *KCP* appeal, the Appellate Division disagreed.[4] The Appellate Division held that the trial court "was not required to apply the 'entire fairness' standard to the transaction…." The Appellate Division noted that in *Alpert*, the New York Court of Appeals had said that "[C]orporate freeze-outs of minority interest by mergers occur principally in three distance manners: (1) two-step mergers, (2) parent/subsidiary mergers, and (3) 'going-private' mergers where the majority shareholders seek to remove the public investors …. This court does not now decide if the circumstances which will satisfy the fiduciary duties owed in [a] two-step merger will be the same for the other categories." The Appellate Division then noted that the *KCP* case required the approval of a majority of the minority shareholders, which had not been required in *Alpert*. Additionally, Cole, an interested party, "did not participate when the Company's board of directors voted on the merger." Accordingly, the Appellate Division concluded that "pre-discovery dismissal based on the business judgment rule was appropriate since there are no allegations sufficient to demonstrate that the members of the board or the special committee did not act in good faith or were otherwise interested."

The *MFW* Decisions in Delaware

Meanwhile, in 2013 and 2014, important rulings regarding transactions with controlling shareholders were issued — first by the Delaware Chancery Court and then by the Delaware Supreme Court — in Kahn v.

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[3] *Alpert v. 28 Williams St. Corp.*, 63 N.Y.2d 557, 473 N.E.2d 19, 483 N.Y.S.2d 667 (N.Y. 1984).

[4] *In the matter of Kenneth Cole Productions, Inc. Shareholder Derivative Litigation*, 122 A.D.3d 500, 998 N.Y.S.2d 1, 2014 N.Y. App. Div. LEXIS 8037, 2014 NY Slip Op 08105 (App. Div. 1st Dep't 2014).

M&F Worldwide Corp. (MFW).[5] The long-standing rule in Delaware had been that "where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts," as noted by the Delaware Supreme Court in 1983 in *Weinberger v. UOP*.[6] That rule had evolved by 1994 in *Kahn v. Lynch* such that a defendant could flip the burden of proof to the plaintiff if the defendant showed that either (1) "the transaction was approved by a well-functioning committee of independent directors" or (2) "the transaction was approved by an informed vote of a majority of the minority stockholders."[7]

In *MFW*, the Chancery Court and then the Delaware Supreme Court considered what should be the standard if the transaction was preconditioned on both criteria. Such a circumstance had not previously arisen in the Delaware courts. Chancellor Leo Strine and then, on appeal, the Delaware Supreme Court agreed that when both criteria were met, the courts should fall back to the business judgment rule. As the Delaware Supreme Court put it, "where the controller irrevocably and publicly disables itself from using its control to dictate the outcome of the negotiations and the shareholder vote, the controlled merger then acquires the shareholder-protective characteristics of third-party, arm's-length mergers, which are reviewed under the business judgment standard."

The Checklist

In the Delaware Chancery Court, Chancellor Strine reduced all of the sub-elements of the criteria for the use of the business judgment rule in a controlling shareholder merger transaction to the following checklist of six points. "The business judgment rule is only invoked if:

- the controller conditions the procession of the transaction on the approval of both a special committee and a majority of the minority stockholders;
- the special committee is independent;
- the special committee is empowered to freely select its own advisors and to say no definitively;
- the special committee meets its duty of care;
- the vote of the minority is informed; and
- there is no coercion of the minority."

The Delaware Supreme Court adopted this checklist in full.

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[5] *In re MFW Shareholders Litigation*, No. 6566-CS (Del. Chancery 2013); *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

[6] *Weinberger v. UOP, Inc.,* 457 A.2d 701 (Del. 1983).

[7] *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110 (Del. 1994).

Back to *KCP* in New York

Plaintiffs in *KCP* appealed again, to the highest court in New York, the Court of Appeals. The Court of Appeals discussed the development of the caselaw both in New York and in Delaware before adopting entirely the reasoning of the Delaware courts in *MFW* as well as their six-point checklist.

The Court of Appeals began with "the general principle that courts should strive to avoid interfering with the internal management of business corporations." The court said it "long adhered to the business judgment rule" when corporate directors and officers "exercise unbiased judgment" and that "Courts will defer to those determinations if they were made in good faith." The Court of Appeals said that "absent fraud or bad faith," "courts should respect those business determinations and refrain from any further judicial inquiry." This principle is tempered by the notion that "the court may inquire as to the disinterested independence of the members of that committee and as to the appropriateness and sufficiency of the investigative procedures chosen and pursued by the committee."[8]

The New York Court of Appeals then noted that its prior decision in *Alpert* was distinguishable from *KCP* because there had been "no independent committee and no minority shareholder vote." The court agreed with the *KCP* defendants that the Delaware rule in *MFW* should apply. The court summed up that the "standard set forth in *MFW* reinforces that the business judgment rule is our general standard of review of corporate management decisions, and is consistent with this Court's statement in Auerbach that the substantive determination of a committee of disinterested directors is beyond judicial inquiry under the business judgment rule, but that courts 'may inquire as to the disinterested independence of the members of [a special] committee and as to the appropriateness and sufficiency of the investigative procedures chosen and pursued by the committee.'" The Court of Appeals held that "minority shareholders are sufficiently protected by *MFW*'s conditions precedent to the application of that standard in going-private mergers," and adopted the Delaware six-point checklist in full.

Regarding the practical implications of its decision on future lawsuits challenged on a motion to dismiss, the court said "a complaint is sufficient to state a cause of action for breach of fiduciary duty – and the plaintiff may proceed to discovery – if it alleges 'a reasonably conceivable set of facts' showing that any of the six enumerated shareholder-protective conditions did not exist." "Conclusory allegations," "bare legal assertions with no factual specificity" and "mere speculation" are insufficient.[9]

If a case proceeds through discovery, then on a motion for summary judgment, the court said "a plaintiff must then demonstrate that there is a question of fact as to the establishment or efficacy of any of the enumerated conditions designed to protect the minority shareholders….Finally, if the evidence demonstrates that any of the protections were not in place, then the business judgment rule is inapplicable and the entire fairness standard applies."

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[8] *In the matter of Kenneth Cole Productions, Inc., Shareholder Litigation*, No. 54 (N.Y. Ct. App., May 5, 2016), 2016 NY Slip Op 03545, at 6-7, quoting *Auerbach v. Bennett*, 47 N.Y.2d 619, 623-24, 630-31 (1979).

[9] *Id.* at 13, citing MFW at 645.

Futility

One additional interesting note is the concept of futility. Is it a breach of fiduciary duty if the independent directors fail to investigate a scenario that the controlling shareholder has peremptorily rejected: Selling the company rather than buying out the majority?

The Court of Appeals mentioned the concept only in passing. The court noted that Cole "indicated that he had no desire to seek any other type of merger and, as a stockholder, would not approve of one."[10] The court already had noted that Cole exercised approximately 89 percent of the voting power through his Class A and Class B shares, so it is obvious that it would have been pointless for the special committee to seek a third-party buyer of the company. Yet plaintiffs' counsel had urged in oral argument that a market test was necessary, saying: "So even though Mr. Cole said, I don't want to sell to anybody else, the special committee should have gone out and said, what could we sell Kenneth Cole for, and then gone back to Cole and said, look buddy, you're offering me fifteen dollars; we could sell this company for eighteen right now."[11] But the Court of Appeals did not expand on this specific issue when applying the six-factor test. Instead, the court said that "none of those allegations are sufficient to support more than conclusory assertions that the committee failed to meet its duty of care in negotiating a fair price," and that the price obtained was "higher than the original offer, was within the range of value determined by the committee's independent financial analysts, was recommended by the committee's independent legal counsel and financial advisors, and was higher than the stock's price prior to Cole's announcement that he intended to take the company private."[12]

The court also noted in discussing the facts of the *MFW* case that the controlling shareholder there was not willing to sell. "As in the case before us, the controlling shareholder also made it clear that it was not interested in selling any of its shares, would not vote in favor of any alternative sale or merger and, if the merger was not recommended, its future relationship with the company -- including its desire to remain a shareholder -- would not be adversely affected."[13] But the court did not make any further comment about the logical inference that it would have been futile for the independent committee in that case to solicit bids to buy the entire company.

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[10] *Id.* at 3.
[11] Hearing Transcript at 12.
[12] Slip op. at 15-16.
[13] Slip op. at 9-10, citing *MFW* at 641.

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