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Considering *MFW* for Controller Transactions?

Quick Takes

In this issue of the *Private Equity Digest*, we analyze recent trends in deal parties' implementation of the *MFW* roadmap in controlling stockholder transactions, noting that an increasing number of parties are deciding to forgo the full *MFW* framework, instead choosing merely to "burden-shift" by conditioning the transaction on approval by a special committee alone.

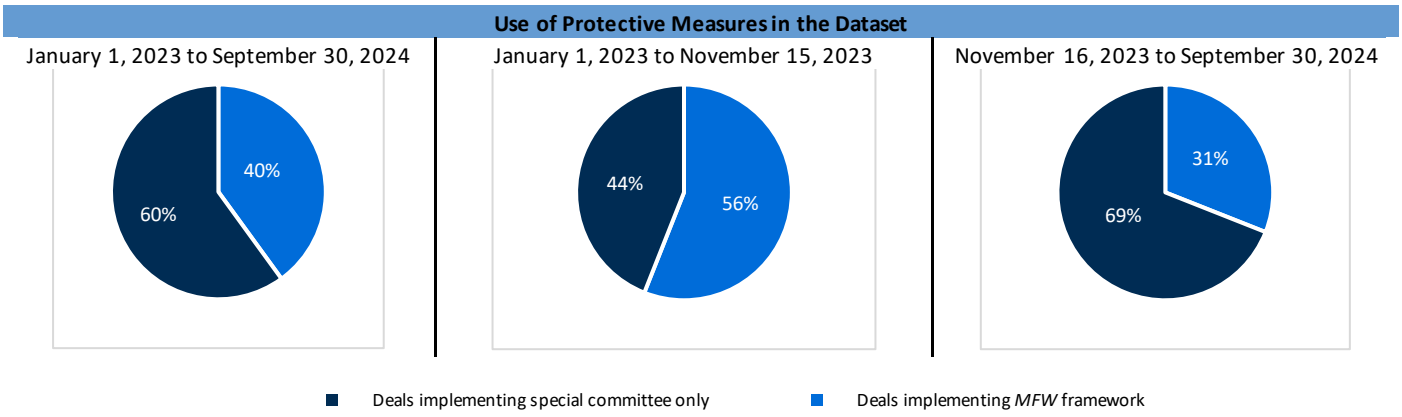
In 2014, the Delaware Supreme Court provided a path to business judgment review for interested controlling stockholder transactions in its landmark decision in *Kahn* v. *M&F Worldwide Corp.*[1] ("*MFW*"). While Delaware's most onerous standard of review, entire fairness, applies by default to these transactions, under the framework upheld in *MFW* and its progeny, deal parties can restore business judgment review if, from the outset of negotiations, the transaction is conditioned on the approval of both a fully empowered and well-functioning committee of independent directors and the fully informed and uncoerced vote of a majority of the minority stockholders (a "*MoM vote*"). If only one of these two procedural protections are adopted, defendants may still shift to plaintiffs the burden to prove the unfairness of the transaction.

As we enter another decade under this regime, some deal parties appear to be questioning whether the benefits of attempting to implement *MFW* are worth its costs, burdens and risks. Our analysis of recent deals indicates that deal parties are indeed deciding to forgo reliance on the full *MFW* framework in increasing numbers, instead choosing merely to "burden-shift" by conditioning the transaction on approval by a special committee alone. We discuss below some possible factors that may be motivating this approach.

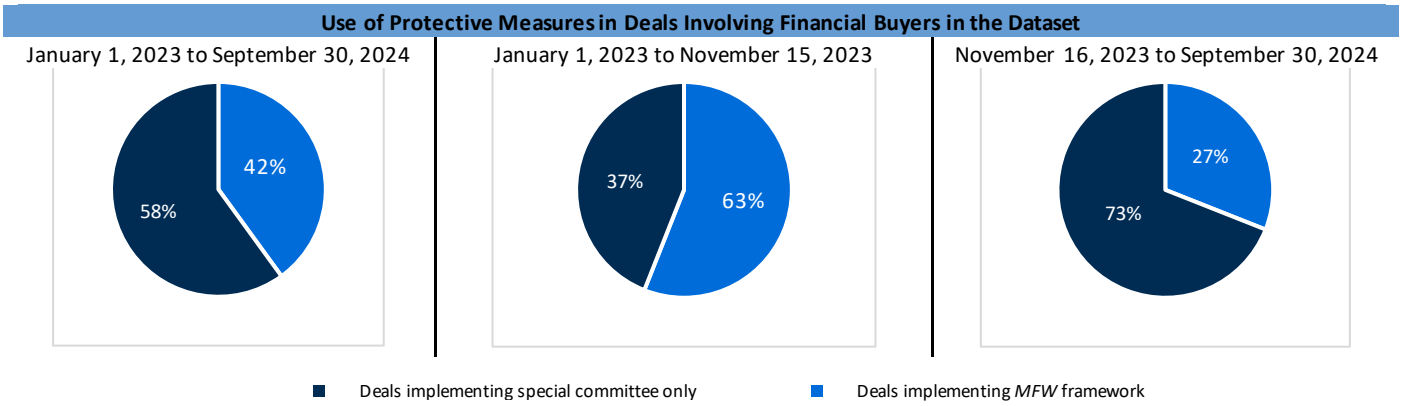
Trends on the Use of the *MFW* Roadmap

To assess market practice, we reviewed deals involving Delaware targets announced between January 1, 2023 and September 30, 2024, where the *MFW* framework was potentially available in order to see whether parties implemented the full framework. Because there is no way to identify the entire universe of these transactions, our dataset was created based on public disclosure and the methodology noted at the end of this article. Based on our review, we identified 25 "*MFW*-eligible" deals during this period. Nineteen of these deals involved a financial buyer, including private equity firms.[2]

A few interesting market practice points came out of this. Of these deals, only 40% (10 of 25 deals) used both a special committee and a MoM vote in reliance on the full *MFW* framework.[3] Further, the *MFW* adoption rate declined over the period reviewed. During the first half of the period covered, ~56% (five of nine deals) implemented the full *MFW* framework, but during the latter half of the period covered, this declined to ~31% (five of 16 deals).



The trends were similar when looking only at the subset of deals in the dataset involving financial buyers. Of these deals, ~42% (eight of 19 deals) used both a special committee and a MoM vote in reliance on the full *MFW* framework. Financial buyer deals in the dataset also reflected the trend of the *MFW* adoption rate declining over the period reviewed. During the first half of the period covered, ~63% (five of eight deals) implemented the full *MFW* framework, but during the latter half of the period covered, this declined to ~27% (three of 11 deals).



These trends suggest that deal parties in controller transactions are indeed forgoing the possibility of obtaining business judgment review of the transaction, and are relying at an increasing rate on the burden-shifting benefits obtained through the use of a special committee alone. So, why is this happening?

Background on *MFW*

Before we dive into that question, a little background on Delaware standards of review for fiduciary duty claims is needed. The default standard of review in Delaware is the business judgment rule, which presumes that directors make decisions on an informed and independent basis, with due care, in good faith and free of material conflicts of interest. Where business judgment review applies, the court will defer to the directors' business judgment, often resulting in a pleadings-stage dismissal of the litigation.

When a controlling stockholder stands on both sides of a transaction and receives a non-ratable benefit, however, the default standard of review under Delaware law is entire fairness. Entire fairness requires defendants to prove that the challenged transaction was entirely fair, taking into account a unitary analysis of process and financial considerations, i.e., whether there has been fair dealing and fair price. If entire fairness applies, a claim is unlikely to be dismissed at the pleadings stage.

MFW held that in a squeeze-out merger, the deal parties could move from the default entire fairness standard back to business judgment review if the transaction is conditioned *ab initio* on *both* a fully empowered and well-functioning committee of independent directors and a fully informed and uncoerced MoM vote. The Delaware Supreme Court recently clarified in *In re Match Group, Inc. Derivative Litig.*[4] that this framework will apply not only in squeeze-out mergers, but to any transaction where the controlling stockholder stands on both sides of the transaction and receives a non-ratable benefit. *Match* also clarified that the special committee implemented for *MFW* purposes must be wholly (and not just majority) independent to restore business judgment review.

As an intermittent step, under *Kahn* v. *Lynch,*[5] rather than choosing to implement both prongs of the *MFW* framework to obtain business judgment review, defendants may shift the burden of showing entire fairness to the plaintiff challenging the conflicted controller transaction by implementing only one of the protective measures (typically the use of an independent special committee).

Why Are Parties Increasingly Forgoing *MFW?*

So why are more deal parties forgoing the two-pronged *MFW* roadmap, and instead relying on burden-shifting through the use of a special committee? The simple answer may be that the *MFW* framework is not proving to be a significant deterrent from being subjected to Delaware litigation, and moreover, that litigation is often surviving beyond the pleadings stage.

In our dataset, 40% (10 of 25 deals) were challenged by stockholders in litigation alleging a breach of fiduciary duty or appraisal litigation filed in Delaware.[6] Of the deals facing litigation, five implemented both protective measures and five implemented only

one protective measure. In other words, of the deals challenged by Delaware litigation, half implemented both prongs of the *MFW* framework and half utilized a special committee only. The trend is similar for the subset of financial deals in the data set; ~42% (eight of 19 deals) were challenged by stockholders in litigation alleging breach of fiduciary duty or appraisal litigation filed in Delaware. Of the eight financial deals facing litigation, four implemented both protective measures and four implemented only one protective measure. Therefore, it appears that stockholders are not significantly deterred from bringing Delaware litigation challenging the transaction based on whether the *MFW* framework or a special committee only was used.

Moreover, in the past 10 years since the Delaware Supreme Court's decision in *MFW*, such litigation has often survived beyond the pleadings stage. In another article, we determined that in this time, the rate of pleadings-stage dismissals based on an *MFW* defense has only been 39%.[7] Therefore, deal parties may be uninclined to introduce the additional deal risk brought on by implementation of the MoM vote when the risk of costly, post-pleadings stage litigation remains relatively high, regardless of their implementation of the full *MFW* framework.

Conclusion

Based on our observations, deal parties are, with increasing frequency, forgoing the possibility of obtaining business judgment review of controller transactions, and are instead relying on the burden-shifting benefits obtained through the use of a special committee. Likely reasons for this are not only the high costs and deal risks associated with obtaining a MoM vote, but also that attempted implementation of the *MFW* framework has not proven to be a significant litigation deterrent and thus is not a certain path to business judgment. In addition, historically, where such litigation is brought, it often survives beyond the pleadings stage. To this end, parties may be reasoning that if there is a relatively high risk that they are going to end up in costly, post-pleadings stage litigation regardless of the procedural path chosen, a well-functioning independent special committee can still provide the appropriate protection of minority interests, even in a controller transaction, with less cost and less risk.

Please note that this article is not meant to promote the abandonment of *MFW* procedures or reliance on a special committee alone. We mean only to provide some data for discussion. Parties are advised to consider their particular facts and to discuss these considerations with their advisors to determine the appropriate approach and structure of their deal.

Note on Methodology: We started with a dataset of deals involving public Delaware targets announced between January 1, 2023 and September 30, 2024, and which disclosed use of a target special committee (based on Deal Point Data information as of October 14, 2024). We assumed that this would be an initial approximation of deals where the parties determined that some conflict existed. This necessarily excluded deals that might have benefited from *MFW*, but where the parties chose to forgo both prongs, as it would be impractical to identify those transactions. We then reviewed the disclosure for the deals to eliminate (i) deals where we believed that the special committee was not used for conflict reasons, or otherwise where *MFW* would not be implicated, (ii) any withdrawn deals for which no definitive agreement was reached and (iii) deals for which there was insufficient disclosure (primarily recently announced deals). Based on this, we believe we have collected a dataset of 25 *MFW*-eligible transactions for the period specified.

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1 88 A.3d 635 (Del. 2014).

2 To determine buyer type, we relied upon the categorization by Deal Point Data.

3 In at least one of the transactions, the transaction was subject to a supermajority vote of the minority stockholders (not simple majority vote).

4 315 A.3d 446 (Del. 2024).

5 638 A.2d 1110 (Del. 1994).

6 We note that aside from these 10 deals, three deals in the dataset were the target of petitions filed in the Delaware Court of Chancery seeking the inspection of books and records under Section 220 of the Delaware General Corporation Law. In addition, note that of the 15 deals in which no litigation alleging a breach of fiduciary duty or no appraisal litigation was filed, seven were pending. In such cases it is possible that stockholders are waiting for the outcome of the relevant stockholder vote to determine whether to bring an action for breach of fiduciary duties. Furthermore, in one deal in which no such litigation was filed, the parties withdrew the deal after announcing a definitive agreement.

7 Bouchard, Andre, *MFW Meets Its Match*, Directors & Boards (Sept. 13, 2024) (available at https://www.directorsandboards.com/legal-and-regulatory/the-courts/mfw-meets-its-match/).

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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