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Delaware Court of Chancery Extends *M&F Worldwide* Doctrine to Third Party Transactions with a Selling Controller

Recently, in *In re Martha Stewart Living Omnimedia, Inc. Stockholder Litigation*, in an opinion by Vice Chancellor Slights, the Delaware Court of Chancery extended the *Kahn* v. *M&F Worldwide* roadmap for invoking business judgment review in controller buyouts to third-party transactions where the controller acts as a seller only, but is purported to receive disparate consideration. Under the roadmap, the court found that the sale of Martha Stewart Living Omnimedia, Inc. ("MSLO") to Sequential Brands Group, Inc. satisfied *M&F Worldwide*'s requirements to invoke business judgement review, and because plaintiffs did not plead a claim for waste, their claims would be dismissed.

Background

Following a failed approach to selling the company, the MSLO board determined to engage in a targeted search for a buyer. Martha Stewart, the undisputed controlling stockholder of MSLO who held 88.8% of its voting control, indicated that a targeted search was her preference over a broad public auction. Shortly thereafter, Sequential, a party that had expressed an interest in engaging a transaction several months prior, submitted an indication of interest at $6.20 per share, payable 50% in cash and 50% in stock. After entering into a confidentiality agreement with MSLO and conducting diligence, Sequential increased its offer to $6.25 per share, subject to MSLO renegotiating more favorable terms on a certain publishing contract, or $5.75 per share, if such negotiations were unsuccessful. Importantly, the revised proposal was also conditioned on approval by a majority of the minority shares of MSLO.

Initially, the special committee determined that negotiations with Sequential regarding a sale of MSLO should precede Stewart's negotiations with Sequential regarding her post-closing contractual arrangements. However, following the aforementioned indication of interest from Sequential, the special committee authorized Stewart to negotiate her contractual relationships simultaneously, subject to the special committee being able to review those arrangements before determining whether to recommend them to the MSLO board.

Sequential later submitted a revised bid with two alternatives: (i) a purchase price of $6.15 per share with a no-shop provision and a termination fee of 3.75% or (ii) a purchase price of $6.00 per share, a go-shop period and a termination fee of 3.75%. Both alternatives included unlimited match rights for Sequential, information rights and $2.5 million in expense reimbursement for Sequential if MSLO stockholders did not approve the merger. The special committee sought a higher price of $6.65 per share, but Sequential did not move from its $6.15 offer. Upon learning that Stewart negotiated for reimbursement from

Sequential of up to $4 million of her fees in negotiating post-closing arrangements, which she was not prepared to limit or alter, the special committee abandoned its request for a higher price and instead sought and received a 30-day post-signing go-shop with match rights. Ultimately, MSLO entered into a merger agreement with Sequential at $6.15 per share, which the stockholders could elect to be paid in cash or Sequential common stock. The agreement also contained a termination fee of $7.8 million during the go-shop, which would increase to $12.8 million after the go-shop. The transaction was subject to a nonwaivable condition that it be approved by a majority of the minority MSLO stockholders. When put to the vote of stockholders, 99% of the minority stockholders approved the transaction. Simultaneous to the signing of the merger agreement, Stewart entered into an employment agreement and registration rights agreement with Sequential. She also entered into an amended license agreement with Sequential that extended the terms of the license agreement that she had with MSLO, and an intellectual property agreement with Sequential largely identical to her existing agreement with MSLO.

Plaintiffs, former MSLO stockholders, brought breach of fiduciary duty claims and related aiding and abetting claims against Sequential. The defendants moved to dismiss.

Analysis

In dismissing the claims against Stewart and Sequential, the court made the following key holdings:

- *The breach of fiduciary duty claims against Stewart should be reviewed under the business judgment standard because she did not engage in a conflicted transaction.* Plaintiffs argued that Sequential *decreased* its offer for MSLO following negotiations with Stewart, arguing that Sequential diverted money that could otherwise be paid to the minority stockholders into "side deals" with Stewart. The court found, however, that plaintiffs misstated the facts. Sequential actually *increased* its offer following negotiations with Stewart from $5.75 per share (the applicable price if the publishing contract was not successfully renegotiated) to $6.15 per share. Moreover, plaintiffs failed to plead nonconclusory facts that the side deals provided Stewart with markedly more lucrative post-merger arrangements. Further, the court found that it was Sequential (not Stewart) that requested that the post-closing contractual arrangements be negotiated simultaneously and that Stewart's side deals with Sequential were not an improper diversion of consideration from the minority stockholders due to their relatively insignificant amount, and in any event "ultimately facilitated the Merger and enabled stockholders to realize premium value for their shares."

- *Even if Stewart had engaged in a conflicted transaction through receipt of disparate consideration, the transaction should be reviewed under the business judgment standard because it satisfied the requirements of* M&F Worldwide.

    - Stewart had argued that business judgment review should apply to the transaction under *In re John Q. Hammons Hotels Inc. Shareholder Litigation* and *Southeastern Pennsylvania*

Transportation Authority v. *Volgenau*, cases involving one-sided controller transactions in which the controller received disparate consideration. However, because *Hammons* and *Volgenau* were decided after the development of a full evidentiary record (on motions for summary judgment), unlike *M&F Worldwide* (which can apply at the pleadings stage), they did not require that the procedural protections of a special committee and approval by a majority of the minority apply "*ab initio*." Thus, *Hammons* and *Volgenau* do not address the critical question here: whether *pleadings-stage* business judgment deference is appropriate when minority stockholders allege that a controlling stockholder competed with them for consideration. The court found that given the potential for conflict created by disparate consideration in one-sided controller transactions, it was equally important to ensure that the process is designed from the outset to protect the minority stockholders. Therefore, the court found that the more formalistic framework from *M&F Worldwide*, requiring the procedural protections to be in place *ab initio*, were applicable.

- *However, the correct time to determine whether the* M&F Worldwide "ab initio" *requirement is met in one-sided controller transactions is when the "controlling stockholder actually sits down with an acquiror to negotiate for additional consideration" since that is when the potential conflict with the minority surfaces.* The court reasoned that so long as the procedural protections are implemented before then, all parties, including the controlling stockholder, enter negotiations aware that the special committee and the majority of the minority stockholder will have final approval of the transaction with the disparate consideration for the controller. The protections do not have to be in place at the outset of discussions between the target and the third party if there is not yet any disparate consideration being offered to the controller because the interests of the controller and the minority are aligned and have yet to diverge.

- *The merger with Sequential satisfied the* M&F Worldwide *framework, and therefore, the business judgment rule applied.* The court determined that each member of the special committee was independent of Stewart and that the committee was well-functioning. Among other things, it had a broad mandate to negotiate, had the power to say "no" to any transaction, negotiated "vigorously" on price and ultimately secured a post-closing go-shop despite Sequential's initial reluctance to agree to this term. In addition, the transaction was conditioned *ab initio* (under the standard set forth by the court described above) on approval of the majority of the minority stockholders since Sequential did not approach the special committee about negotiating with Stewart until *after* the nonwaivable majority of the minority condition was in place. Moreover, the majority of the minority vote was uncoerced and fully informed. Therefore, having satisfied the *M&F Worldwide* framework, because plaintiffs did not make a waste claim, business judgment review was applicable to the merger between MSLO and Sequential and the fiduciary duty claims against Stewart were dismissed.

- *Because there was no underlying breach of fiduciary duty by Stewart, the court dismissed the aiding and abetting claim against Sequential.* An essential element of an aiding and abetting claim is a breach of fiduciary duty. Because, as discussed above, no breach existed, the plaintiffs' aiding and abetting claim against Sequential was dismissed.

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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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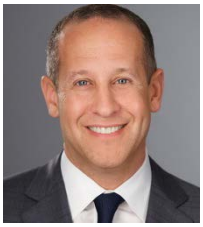

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