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DE Court Dismisses Challenge to Freeze-Out Merger in *Books-a-Million* Litigation

In *In re Books-a-Million, Inc. Stockholders Litigation*,[1] the Delaware Court of Chancery dismissed a stockholder challenge to a "freeze-out" merger between a company and its controlling stockholder. The merger was negotiated by a special committee of independent directors and approved by a majority of the outstanding minority shares. Applying the Delaware Supreme Court's decision in *Kahn v. M&F Worldwide Corp.*,[2] the court found that the merger was protected by the business judgment rule. In reaching its decision, the court was influenced by the evidentiary record created by the defendants through board resolutions, meeting minutes, and the background section of the proxy statement, which helped demonstrate their compliance with the various elements of the *M&F Worldwide* framework.

Background

In 2015, the controlling family of Books-a-Million, Inc., proposed to acquire the outstanding minority shares in a cash-out merger (also known as a "freeze-out"). The company's board of directors responded by forming a special committee, which hired its own financial and legal advisors. During the negotiations, the special committee also solicited third-party bids to acquire the company. One third party submitted a proposal to acquire the entire company at a price per share that was higher than the controlling family's offer to the minority stockholders. The controlling family indicated, however, that it was not interested in selling its shares. This effectively left the special committee with two options: reach a definitive agreement with the controlling family or reject their proposal and maintain the status quo. After five months of negotiations, the special committee recommended a revised transaction with the controller, the closing of which was conditioned on the approval of a majority of the outstanding minority shares. The merger was consummated in December 2015.

Applying *M&F Worldwide*

Under the Delaware Supreme Court's decision in *M&F Worldwide*, a freeze-out merger will be protected by the business judgment rule and not reviewed under the "entire fairness" standard if all of the following conditions are present: (i) the controller conditions the transaction on the approval of both a special committee and a majority of the outstanding minority shares; (ii) the special committee is independent; (iii) the special committee is empowered to freely select its own advisors and say "no" to the controller; (iv) the special committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) the controller does not coerce the minority stockholders. The *Books-a-Million* court found that each of these elements was met and dismissed the stockholder's complaint with prejudice.

[1] Consol. C.A. No. 11343-VCL, mem. op. (Del. Ch. Oct. 10, 2016).

[2] 88 A.3d 635 (Del. 2014).

Take-Aways from *Books-a-Million*

- *The M&W Worldwide Framework is Achievable*. Prior to *M&F Worldwide*, freeze-out mergers generated significant litigation because they were generally presumed to be subject to the stringent "entire fairness" standard of review, which resulted in claims that rarely could be dismissed at the pleadings stage. *M&F Worldwide* gives controllers a path to obtain business judgment rule protection so long as the controller and the special committee adhere to the criteria in that opinion. Following *M&F Worldwide*, however, it was not known whether it would be applied in such a stringent way that it would be difficult to obtain its benefits. *Books-a-Million* indicates that Delaware courts will not apply *M&F Worldwide* in a commercially impractical manner and that the business judgment rule is obtainable.[3] In particular, the court noted that, although claiming the directors acted in bad faith was a "theoretically viable means of attacking the *M&F Worldwide* framework," it would be a "difficult route."

- *Advance Planning*. Controllers must plan carefully if they wish to take advantage of *M&F Worldwide*. As noted above, there is an achievable path for business judgment rule protection, but it still requires that certain conditions be met. In particular, the controller's proposal must be conditioned from the outset on approval from a special committee and a majority of the minority shares.

- *Creating a Record*. Boards and their advisors should create an objective record to help illustrate the discharge of the directors' duties. The *Books-a-Million* court noted that "if the defendants have described their adherence to the elements identified in *M&F Worldwide* 'in a public way suitable for judicial notice, such as board resolutions and a proxy statement,' then the court will apply the business judgment rule" unless the plaintiffs can successfully rebut those elements. It is also important to understand how the board's and special committee's process will be scrutinized by investors and a court. In *Books-a-Million*, the vice chancellor observed that the special committee met 33 times, negotiated over five months, solicited third-party proposals, made two counteroffers to the controlling family, and ultimately negotiated a 20% price increase over the controller's initial proposal.

- *Director Independence*.

    - Obviously, a special committee must consist of disinterested and independent directors.

    - The Books-a-Million special committee's process was not undermined, however, by the fact that its composition changed at an early stage of the process. The board initially appointed all three of its "independent" directors to the committee. After discussions with counsel, however, one of those directors resigned from the committee due to unspecified "social and civil relationships" with the controlling family. The court noted that the director "only served on the Committee for a matter of days," "did not participate in the negotiation of the merger," and "voluntarily resigned." The court held that "a prompt resignation ... does not undermine the Committee's independence here." The court was also not persuaded that the director's later attendance at a special committee meeting for purposes of hearing a fairness presentation from the committee's financial advisor had somehow compromised the committee's independence.

[3] *See also Swomley v. Schlecht*, C.A. No. 9355-VCL (Del. Ch. Aug. 27, 2014) (dismissing a challenge to a freeze-out merger under *M&F Worldwide*).

  - Companies should continue to be mindful of the interaction between the independence standards under stock exchange listing requirements and state common law. Delaware courts have observed that independence requirements under the New York Stock Exchange's listing standards "cover many of the key factors that tend to bear on independence … and they are a useful source for this court to consider when assessing an argument that a director lacks independence."[4] Nevertheless, there may be reasons that an otherwise "independent" director should not serve on a transaction-specific special committee.

- *Evaluating Third-Party Alternatives*. The court held that the special committee did not breach its fiduciary duty of care or loyalty by pursuing the controlling stockholder's transaction over a nominally higher price per share offered by a third-party buyer. The court explained that the special committee's decision to solicit third-party proposals tested the controlling family's prior statement that it "would stick to [its] buyer-only stance when presented with an opportunity to sell." It also provided the special committee with additional information on which to judge the financial adequacy of the controller's proposal. The court also held that the controlling family did not have any legal duty to sell to the third party.[5] This is an important recognition that a special committee may have limited options when a controller refuses to sell. The court also opined that the difference in price between the controller and the third party presumably reflected the fact that the third party had to pay a control premium whereas the controller did not.

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[4] *In re MFW S'holders Litig.*, 67 A.3d 496, 510 (Del. Ch. 2013).

[5] *See also Mendel v. Carroll*, 651 A.3d 297 (Del. Ch. 1994).