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N.Y. Court of Appeals Adopts Business Judgment Rule, with Conditions, for Going-Private Mergers

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The New York Court of Appeals has followed Delaware in holding that the business-judgment rule applies to going-private mergers as long as certain shareholder-protective measures are met. The court's May 5, 2016 decision in *In the Matter of Kenneth Cole Productions, Inc. Shareholder Litigation*, Case No. 54, adopts the standard set forth by the Delaware Supreme Court in *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) ("*MFW*"), and relaxes judicial scrutiny of controlling shareholders' going-private mergers if the transactions provide certain protective conditions to safeguard the interests of minority shareholders.

Before the merger at issue, Kenneth Cole Productions' ("KCP's") majority shareholder had held approximately 89% of KCP's voting power. In early 2012, the majority shareholder announced his intention to offer to buy the minority shares and take KCP private. The offer was conditioned on approval by both a special committee established by the KCP board and a majority of the minority shareholders. The special committee negotiated with the majority shareholder and agreed on a merger price, which 99.8% of the minority shareholders then approved.

Certain shareholders sued the board for breach of fiduciary duty. The trial court dismissed the case; the Appellate Division affirmed; and the plaintiffs sought review in the Court of Appeals.

The Court of Appeals was confronted with two competing standards for going-private freeze-out mergers. Plaintiffs argued for application of the entire-fairness standard, which places the burden on directors to establish both fair process and fair price in effectuating the transaction. Defendants, on the other hand, argued in favor of the more deferential business-judgment rule, which rests on the premise that courts are ill-equipped to evaluate corporate decisions made in good faith.

The court found a middle ground and adopted the Delaware Supreme Court's test from *MFW*, which applies the business-judgment rule if certain conditions protective of minority shareholders are met. In the context of going-private mergers, or buyouts by a controlling shareholder, the *MFW* standard – which is now New York law – enumerates a set of six shareholder-protective conditions that must be satisfied for the business-judgment rule to apply:

- The controller must condition the transaction process on the approval of both a special committee of the board and a majority of the minority stockholders;
- The special committee must consist of independent directors;
- The special committee must be empowered to freely select its own advisors and to say no definitively;
- The special committee must meet its duty of care in negotiating a fair price;
- The vote of the minority shareholders must be an informed vote (*e.g.*, the disclosures about the transaction must be adequate); and
- The minority's vote must not be coerced.

The Court of Appeals walked through each of the six conditions and concluded that the majority shareholder and the other KCP directors had observed the appropriate protections and that the plaintiffs had failed to show fraud or bad faith. The court therefore affirmed the Appellate Division's application of the business-judgment rule.

Adoption of the business-judgment rule over the entire-fairness standard can be seen as defendant-friendly, in that the business-judgment rule requires a plaintiff challenging a going-private merger to plead and prove facts demonstrating that any of the six shareholder-protective conditions were not met. "Conclusory allegations or bare legal assertions with no factual specificity are not sufficient, and will not survive a motion to dismiss." But the Court of Appeals also noted with approval the Delaware Supreme Court's observation that application of the business-judgment rule in conjunction with the shareholder-protective conditions is likely to encourage controlling shareholders to structure freeze-out mergers so as to protect minority shareholders' interests.

The combination of the deferential business-judgment rule with safeguards designed to protect the minority strikes a balance between minority shareholders wary of interested-director transactions and controlling shareholders and directors seeking to protect their reasoned business decisions from judicial interference. The Court of Appeals' decision can be found here. We previously blogged about the Appellate Division's decision here.

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