

M&A Update

Delaware Supreme Court Clarifies the “*Ab Initio*” Requirement for Business Judgment Review of Controlling Stockholder Transactions in *Flood v. Synutra*

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In *Flood v. Synutra Int’l Inc.*, the Delaware Supreme Court clarified its holding in *Kahn v. M&F Worldwide Corp.* (“*MFW*”). In *MFW*, the Court held that the business judgment rule—rather than the entire fairness standard—applies to a controlling stockholder transaction if such transaction is conditioned “*ab initio*,” or at the beginning, upon approval of both an independent special committee of directors *and* the informed vote of a majority of the minority stockholders (the “*MFW* Conditions”). At issue in *Flood* was whether the Court of Chancery properly applied the business judgment rule to a controlling stockholder acquisition of Synutra International even though the controlling stockholder did not include the *MFW* Conditions in its initial proposal to acquire Synutra, but instead included such conditions in a follow-up letter sent two weeks later. Chief Justice Strine, writing for the majority, affirmed the Delaware Court of Chancery’s decision, which held that the *MFW* Conditions need not be included in the controlling stockholder’s initial expression of interest for the transaction to be afforded business judgment protection; instead, business judgment protection will be afforded so long as the *MFW* Conditions are in place before any substantive economic negotiations occur between the special committee, the board of directors and the controlling stockholder.

Background

In January 2016, Liang Zhang—who controlled 63% of Synutra’s stock—sent an initial letter to the Synutra board proposing to take Synutra private by acquiring the rest of the stock he did not control at a price of \$5.91 per share. His initial letter, however, did not provide that any such transaction would be conditioned upon satisfaction of the *MFW* Conditions. One week after Zhang’s proposal, the board formed a special committee to evaluate the proposal.

Two weeks after Zhang’s initial proposal, Zhang sent a second letter to the special committee reaffirming his interest in a transaction, which letter included the *MFW* Conditions. On September 8, 2016, after seven months of due diligence and consultation with its advisors, the special committee authorized its financial advisor to negotiate a higher price with Zhang. Following

negotiations, a final price of \$6.05 per share was agreed upon by the special committee and Zhang.

The plaintiff minority stockholders filed class actions challenging the merger, alleging a breach of fiduciary duty by the board in connection with Zhang's acquisition of Synutra. The Chancery Court granted Synutra's motion to dismiss the complaint on the grounds that the *MFW* Conditions were satisfied and that the business judgment rule applied. The plaintiffs appealed, arguing that the Chancery Court misapplied the *MFW* Conditions in two respects: (1) the business judgment rule should not have been applied because the *MFW* Conditions were not put in place "*ab initio*," and (2) the special committee should have applied a heightened business judgment rule standard in which the Court may find that the board violated its duty of care by failing to obtain a sufficient price without a showing of gross negligence by the board.

Takeaways

The *Flood* decision provides key insights for controlling stockholders, sellers and special committees with respect to the proper implementation of the *MFW* Conditions for a controlling stockholder transaction.

- The *MFW* Conditions Must Be in Place Prior to Any Substantive Economic Negotiations Between the Controlling Stockholder and the Special Committee. In *Flood*, the Delaware Supreme Court clarified that the term "*ab initio*" should not be read to impose a bright-line test requiring that the *MFW* Conditions be included in a controlling stockholder's first offer; but instead that they must be in place before any economic substantive negotiations take place. While admitting that the language used in *MFW* may be read as ambiguous as it relates to this point, the Court reasoned that this interpretation is consistent with the common usage of the term "from the beginning," which should not be read narrowly to include only the initial overture, but to more broadly include "the beginning stages of the process that led to the merger." Furthermore, the Court noted that this interpretation achieves the main objective of the requirement; namely to ensure that a controlling stockholder does not use the inclusion of a majority-of-the-minority vote as a "bargaining chip during economic negotiations" with a special committee and to "help replicate a third party process and, simultaneously, incentivize controllers to precommit to the *MFW*'s Conditions early to take advantage of business judgment review." Thus, the *MFW* Conditions will be satisfied so long as the controlling stockholder conditions its offer "at the germination stage of the special committee process, when it is selecting its advisors, establishing its method of proceeding, beginning its due diligence, and has not commenced substantive economic negotiations with the controller."
- Providing a Conflict Waiver for Legal Counsel Does Not Rise to the Level of Substantive Economic Negotiations. The Court found that economic substantive negotiations had not occurred until some point following the delivery of Zhang's second letter, which included the *MFW* Conditions. In doing so, the Court implicitly found that the actions taken in between the

submission of Zhang's initial letter and his second letter did not amount to "substantive economic negotiations" that would render the business judgment rule unavailable. Specifically, during the period between delivery of the first and second letters, Synutra's CFO granted Davis Polk—the company's long-time counsel—a waiver of counsel that allowed it to represent Zhang. The Chancery Court found and the Delaware Supreme Court agreed that the provision of the waiver did not constitute a substantive negotiation of Zhang's offer and that the plaintiffs' complaint pled no facts suggesting that the waiver was exchanged for the *MFW* Conditions or anything else of substance.

- The Court Reaffirmed That No Heightened Duty of Care Exists for Special Committees in *MFW* Transactions. *Flood* reaffirms that once the *MFW* Conditions are duly in place and the business judgment rule is deemed to be the appropriate standard of review for a transaction, there is no heightened level of scrutiny when analyzing a special committee's duty of care. The Court therefore rejected the plaintiffs' argument that it could somehow avoid the business judgment rule by raising questions about the special committee's bargaining proficiency or the fairness of the price that was ultimately agreed to. In doing so, the Court found that because the *MFW* Conditions were imposed on a timely basis, the special committee could only be deemed to have breached its duty of care if it acted with gross negligence. The Court in *Flood* further held that the special committee's conduct was not grossly negligent in light of their extensive deliberations, receipt of extensive advice from its advisors and the level of negotiations it conducted with the controlling stockholder.
- The Dissent Favors a Bright-Line "*Ab Initio*" Requirement. Justice Valihura issued a dissenting opinion, arguing that the "*ab initio*" requirement for the *MFW* Conditions should be a bright-line test requiring that the *MFW* Conditions be included in the controlling stockholder's first written proposal. The dissent reasoned that such a bright-line test is appropriate because inclusion of the *MFW* Conditions in an initial proposal is fully within the control of the controller and would avoid the need for an imprecise, fact-intensive, pleadings-stage inquiry into whether the lack of inclusion impacted the effectiveness of the special committee.

Please click [here](#) for the full opinion.

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