Updates
September 07, 2017

In its opinion in *In re Martha Stewart Living Omnimedia, Inc. Stockholder Litigation*,[1] issued in August 2017, the Delaware Chancery Court addressed a question left open under *Kahn v. M&F Worldwide Corp.*[2] (MFW)—namely, whether the business judgment rule would apply in a challenge to a "one-sided controller transaction" if the procedural protections approved in MFW for "two-sided controller transactions" were followed. The court found that adherence to the procedural protections set out in MFW for controlling stockholder buyouts will also "cleanse" transactions between a controlled corporation and a third party where the controller—although it does not stand on both sides of the transaction—is alleged to have a conflict of interest due to the improper diversion of consideration that should have gone to all stockholders.

In 2015, Martha Stewart Living Omnimedia, Inc. (MSLO) merged with a third-party buyer, Sequential Brands Group, Inc. (Sequential). Martha Stewart, MSLO's controlling stockholder, entered into certain side agreements with Sequential in connection with the merger. The plaintiff MSLO stockholders argued that Stewart breached her fiduciary duty as MSLO's controlling stockholder by entering into side agreements that purportedly diverted consideration that belonged to all stockholders. The existence of this conflict, they argued, required the court to review the transaction with Sequential under the entire fairness standard, Delaware's strictest standard of review.

Court of Chancery Vice Chancellor Joseph R. Slights III disagreed, finding that the side agreements did not represent a conflict for Martha Stewart and that, even if they did, the parties followed the procedural protections outlined in MFW. For both reasons, he concluded that the business judgment rule applied to the pleadings-stage review of what he termed a "one-sided controller transaction," and granted defendants' motion to dismiss.

The decision contains a helpful analysis of what constitutes a conflict when a controller receives separate consideration in a third-party transaction, an issue that frequently bedevils boards of directors of controlled corporations, and sets out a road map for handling such transactions under the MFW protocol.

Backstory Behind the MSLO Decision

MSLO was a media and merchandising company whose founding stockholder, Martha Stewart, held 88.8% of the voting control of MSLO through a combination of high vote Class B common stock and low vote Class A common stock. Stewart was key to the branding and promotion of MSLO's products and had entered into three agreements with the company that reflected her importance to the business: an employment agreement, an IP agreement and a license agreement.

In 2014, Stewart informed the MSLO board (Board) that she had been approached by a third party—"Company A"—about a potential acquisition of MSLO. Due to Stewart's control position and the uncertainty about any potential arrangements between Stewart and an acquirer, the Board formed a special committee of independent directors with broad latitude to explore the transaction with Company A, as well as any alternative transactions, and to retain its own legal and financial advisors. Company A insisted upon negotiating with Stewart on the extension of her agreements at the same time it negotiated the merger terms with the Special Committee. The committee acquiesced, but reserved the right to evaluate the final arrangements. During the negotiations with Company A, Sequential approached MSLO about a possible transaction but the Special Committee initially declined to proceed with Sequential. In the meantime, MSLO's stock rose from $4.73 per share to $6.45 per share on favorable financial results. Company A reached satisfactory terms with Stewart, but when it submitted its best bid of $4.90 per share, the committee rejected it.

The Board then considered next steps, and after taking into account Stewart's preference for a targeted search for a buyer instead of a public auction, the Special Committee began discussions with Sequential. Sequential made an initial proposal to acquire MSLO, but later revised its proposal to acquire MSLO at a slightly lower price if MSLO successfully renegotiated an existing contract with a publishing partner or an even lower price if it did not. The revised proposal was conditioned on approval by a majority of the MSLO shares not owned by Stewart and her affiliates. Like Company A, Sequential insisted on negotiating simultaneously with Stewart on her post-closing arrangements and with the Special Committee on the merger. The Special Committee again acquiesced, subject to its right to review those arrangements before deciding whether to recommend the merger to the full board.

The Special Committee negotiated vigorously on price and terms, obtaining a better price than Sequential had last offered and convincing Sequential to agree to certain procedural protections when it balked at an even higher price proposed by the committee. About the same time, the committee learned that Stewart had negotiated for reimbursement of up to $4 million of the fees she incurred in connection with the negotiation of her post-closing arrangements and was not inclined to alter that arrangement. Upon the recommendation of the Special Committee, the Board approved a merger agreement that gave MSLO stockholders the choice of $6.15 in cash or shares of Sequential common stock of equivalent value, and also provided for a 30-day post-signing, go-shop period, matching rights for Sequential and a termination fee of $7.8 million during the go-shop period and $12.8 million thereafter. The merger agreement included a non-waivable condition that the merger be approved by: (a) a vote of at least the majority of the combined voting power of the Class A and Class B common stock, and (b) the separate vote of at least 50% of the voting power of the Class A common stock not controlled by Stewart.

When the merger agreement was executed, Stewart entered into an employment agreement and a registration rights agreement with Sequential and extended the existing license agreement and IP agreement. She otherwise received the same consideration in the merger as the other MSLO stockholders.

The merger was approved with 99% of the minority stockholders voting in favor of the transaction.

Did Stewart Extract Consideration From Sequential That Should Have Gone to the MSLO Stockholders?

In bringing a challenge to the transaction with Sequential, the plaintiffs argued that the entire fairness standard of review was appropriate because Stewart abused her controlling position by negotiating side deals that diverted consideration from the minority stockholders to herself. They asserted that Sequential had reduced its offer after it negotiated its side agreements with Stewart, since the $6.15 per share price ultimately agreed to was less than Sequential's initial proposal. Vice Chancellor Slights chastised the plaintiffs for their selective interpretation of the proxy statement, noting that the full proxy statement contradicted the plaintiffs' narrative. Although Sequential initially bid $6.20 per share, after diligence it offered two alternatives: $6.25 per share if the publishing contract was renegotiated and $5.75 if it was not. The contract was not renegotiated. Sequential then asked to negotiate Stewart's post-closing arrangements. After those negotiations were completed, Sequential *increased* its offer from $5.75 per share to $6.15. Furthermore, the pleadings did not show that the post-closing side deals, including the extra $4 million to cover Stewart's professional fees, were substantially more lucrative than those Stewart had in place before the merger. The plaintiffs "failed to distinguish the 'new' side deals from the 'old' side deals in any meaningful way that would support the inference that Stewart was extracting consideration from Sequential that otherwise would have gone to the MSLO shareholders."

Finally, Vice Chancellor Slights noted that the side deals could not be a conflict of interest invoking the entire fairness standard of review unless those deals "represented an *improper* diversion of consideration." Here, the side deals generally tracked the arrangements with Stewart existing prior to the merger and represented a valid quid pro quo for Stewart's continuing commitment to maintain the Martha Stewart brand. "[I]t was entirely proper," Vice Chancellor Slights noted, "for Sequential to pay, and for Stewart to accept, extra consideration . . . to secure the immeasurable value of that commitment." Accordingly, "these fair value side deals ultimately facilitated the Merger and enabled stockholders to realize premium value for their shares." Since plaintiffs had failed to adequately plead the existence of a conflict, the Vice Chancellor held that the business judgment standard of review applied.

Should MFW Govern One-Sided Controller Transactions and, If So, Did the Parties Appropriately Implement the MFW Protective Mechanisms to Avoid Entire Fairness Review?

In MFW, the Delaware Supreme Court ruled that the business judgment rule would be applied to transactions in which a controller stands on both sides if the transaction was conditioned, at the outset, on satisfaction of certain procedural requirements, including: (1) approval by an independent and well-functioning special committee, and (2) approval by a majority vote of fully-informed minority stockholders.[3] Although neither side initially argued whether the requirements of MFW applied to one-sided controller transactions like the MSLO deal, or, if they did, whether or not those requirements had been satisfied, Vice Chancellor Slights requested supplemental briefing on these issues. The plaintiffs did not dispute that MFW provided a road map for one-sided controller transactions, but argued that the parties veered off course—and that the transaction should therefore be reviewed under the entire fairness standard—because the transaction was not conditioned *from the outset* on approval by the Special Committee and a fully informed majority of the minority vote. Stewart and Sequential argued that other Delaware cases involving one-sided controller transactions—not MFW—governed the disparate consideration scenario involved in this deal; alternatively, if MFW did apply, they had satisfied the procedural requirements of that case.

Vice Chancellor Slights determined that MFW should apply in this case, noting that "[t]he need to incentivize fiduciaries to act in the best interests of minority stockholders [by making business judgment rule protection available] . . . is equally important in one-sided and two-sided conflicted controller transactions." However, as with a two-sided controller buyout, where the MFW court emphasized that the procedural protections must be in place "*ab initio*," it is critical that the parties all "appreciate *from the outset* that the terms of the deal will be negotiated and approved by a special committee free of the controller's influence and that a majority of the minority stockholders will have the final say on whether the deal will go forward." [emphasis added]

After dispensing with the plaintiffs' argument that the Special Committee was conflicted and ineffective, the vice chancellor found that the majority of the minority vote condition had been properly implemented at the "outset" because the correct time for assessing whether the MFW "*ab initio"* requirement has been met is the point where the controlling stockholder actually sits down with an acquirer to negotiate for additional consideration, *not* at the commencement of the transaction. Because the Special Committee allowed Stewart to negotiate concurrently with Sequential on her side arrangements only after Sequential had committed to providing for a non-waivable majority of the minority vote, the timing requirement was satisfied. The plaintiffs made no credible allegations of misstatements or omissions in the proxy statement that would have called the vote into question, or that Stewart coerced the MSLO stockholders in any way.

In sum, the plaintiffs did not show that the parties had failed to comply with the MFW elements. Consequently, the business judgment rule applied, and the transaction could only be challenged on the basis of waste, an exacting standard that the plaintiffs failed to assert and, according to Vice Chancellor Slights, could not have conceivably met.

Guidance for Third-Party Transactions With Controller-Side Arrangements

Martha Stewart Living Omnimedia provides practical guidance for structuring a sale of a controlled company to a third party where a buyer wishes to negotiate separate arrangements with a controlling stockholder:

1. Form and Empower an Independent Special Committee Before Any Substantive Discussions Begin Between the Controller and the Potential Buyer. As with any Special Committee formed to consider the sale of the company:

a. Assess and ensure the independence of the Special Committee, especially with respect to the members' ties to the controller.

b. Provide it with a sufficiently broad mandate to approve or reject the current offer and to consider alternative offers.

c. Authorize it to retail any advisors necessary to assist in its work.

2. Anticipate Buyer's Request to Negotiate With the Controller. The Special Committee should review existing arrangements between the controller and the company, and anticipate whether a buyer will seek to extend them, modify them or enter into entirely new arrangements. The committee should fully understand the terms of the existing arrangements and why they are fair to the company. They should consider seeking expert advice on market terms for similar agreements so that they can evaluate any modifications proposed by a buyer.

3. Defer Discussions Between the Buyer and the Controller. Although it is appropriate to seek to defer the discussions between buyer and controller on side agreements until the terms of the primary transaction have been negotiated, in many cases, as was the case with MSLO, the controller's relationship to the company is too integral for a buyer to want to proceed without assurance it can reach satisfactory arrangements with the controller. In that case, the Special Committee should:

a. Extract buyer's agreement to a majority of the minority vote prior to permitting negotiations with the controller on any side agreements, and

b. Insist upon having a final review of the agreements struck with the controller before finally approving the transaction.

4. Negotiate Vigorously the Terms of the Primary Transaction. The Special Committee acts as a surrogate for the minority stockholders. In that capacity, members must actively inform themselves and negotiate for the best terms reasonably available from the buyer, or potentially from alternative buyers, and assess those terms against the option of rejecting the deal entirely. Delaware courts have not required a single process such as a public auction for the sale of the company, but rather, have allowed the board, exercising its business judgment, to determine the process that will serve the best interests of the stockholders.

5. Ensure the Minority Stockholders Are Fully Informed Before the Vote. In *Martha Stewart Living Omnimedia,* the vice chancellor looked repeatedly to the proxy statement to refute the allegations of the complaint. Providing full and accurate disclosure of the process leading to the vote, and ensuring that the proxy statement paints a compelling picture of the work of a diligent special committee and sets out the material information that the committee considered in making its decisions, will help ensure that the efficacy of the majority of the minority vote cannot be challenged.

By adhering to this guidance, the parties can make a third-party transaction in which the controller has an alleged conflict virtually unassailable, even at the pleadings stage. Quite simply, if the entire fairness standard of review applies, plaintiffs almost always win. On the other hand, if the business judgment rule applies, as a practical matter, defendants always win.

ENDNOTES

[1] C.A. No 11202-VCS (Del. Ch, Aug. 18, 2017) ("Martha Stewart Living Omnimedia").

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

[3] "[I]n controller buyouts, the business judgment rule will be applied if and only if: (i) the controller conditions the procession of the transaction on the approval of both a Special Committee and [approval of] a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority." 88 A.3d at 645, as quoted in Martha Stewart Living Omnimedia at footnote 54.

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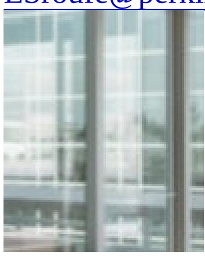

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