

The ‘MFW’ Framework Gains Traction Outside the Merger Context

By Jason J. Mendro and Jeffrey S. Rosenberg

Controlling-stockholder transactions are a regular part of many companies’ business; in some cases, they are essential. When challenged, however, such transactions have often been scrutinized under the entire fairness standard, the most exacting standard under Delaware law. Delaware courts are now increasingly recognizing that corporations can secure the protection of the business judgment rule even for controlling-stockholders transactions by implementing sufficient procedural safeguards. A recent addition to this developing body of law is *IRA Trust FBO Bobbie Ahmed v. Crane*, 2017 WL 7053964 (Del. Ch. Dec. 11, 2017), as revised (Jan. 26, 2018).

In *Crane*, Chancellor Andre Bouchard held that a stock reclassification transaction involving a controlling stockholder was subject to the business judgment rule when the transaction was conditioned from the outset on the procedural precautions considered by the Delaware Supreme



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Court in *Kahn v. M & F Worldwide*, 88 A.3d 635 (Del. 2014) (MFW)—namely, the approval of the transaction by a special committee of independent directors and the majority of the outstanding shares not owned by the controller (i.e., the majority of the minority votes). The controlling stockholder in *Crane* was NRG Energy, Inc. (NRG), a power company that produces, sells, and delivers energy, energy products, and energy services. NRG controlled NRG Yield, Inc. (Yield), a Delaware corporation

that owns a portfolio of income-producing energy generation and infrastructure assets from which dividends can be distributed to stockholders. Following its initial public offering in 2013, Yield had two classes of stock, each of which was entitled to one vote per share. Initially, NRG held approximately 65 percent of Yield’s voting power through its ownership of all of Yield’s Class B shares, and the public stockholders held approximately 35 percent of the voting power through ownership of the Class

A shares. Over time, however, Yield issued additional Class A shares, and by the fall of 2014, NRG's voting control of Yield had been diluted to approximately 55 percent.

Concerned that it could lose its majority voting control if Yield continued to issue Class A shares, NRG proposed that Yield undertake a recapitalization through which the public stockholders would receive non-voting shares in exchange for their voting Class A shares. "From the outset, the proposal was conditioned on obtaining the approval of Yield's public stockholders or a 'majority of the minority' of the outstanding shares of Class A stock not affiliated with NRG." The transaction was also subject to approval by an independent committee of Yield's board of directors, its Corporate Governance, Conflicts and Nominating Committee (the Conflicts Committee). It was undisputed that all members of the Conflicts Committee were independent from NRG.

After multiple rounds of negotiations with the Conflicts Committee, NRG revised its proposal such that Yield would create two new classes of shares: Class C and Class D, which would be issued on a one-to-one basis to Class A and B stockholders, respectively. Although NRG initially

proposed that the newly created class of public shares would be non-voting, the revised proposal entitled them to 1/100 of one vote per share. As part of its revised proposal, NRG also offered to make additional assets available for Yield to purchase.

In May 2015, Yield sought and received stockholder approval for the reclassification. Over 80 percent of the outstanding shares of common stock voted in favor of the reclassification, with a majority of the outstanding shares of Class A stock unaffiliated with NRG voting in favor.

More than a year later, a plaintiff sued on behalf of a putative class of Class A stockholders, claiming that Yield's board of directors breached its fiduciary duties in connection with the approval of the reclassification and that NRG breached its fiduciary duty as the controlling stockholder of Yield by causing Yield to undertake the transaction. The defendants moved to dismiss for failure to state a claim.

The court analyzed the motion in three steps.

First, the court considered whether the reclassification was a transaction to which the entire fairness test would presumptively apply. The court clarified that controlling stockholder transactions are not always subject to

entire fairness review. Rather, the entire fairness test would apply only if the controller engaged in a "conflicted transaction." After surveying recent decisions, the court reasoned that whether the reclassification constituted a conflicted transaction turned on whether NRG received a "non-ratable benefit," i.e., a benefit that would not be shared by the non-controlling stockholders. Noting that it must accept the allegations as true in deciding a motion to dismiss, the court concluded that the plaintiff sufficiently pleaded a nonratable benefit: that the reclassification enabled NRG to maintain its control position. Accordingly, the court found that the reclassification was presumptively subject to the entire fairness test.

Second, the court considered whether conditioning the transaction on the protections utilized in *MFW* would overcome that presumption and secure the application of the business judgment rule. Although the Delaware Supreme Court had applied the *MFW* framework in the context of a squeeze-out merger, Chancellor Bouchard observed in *Crane* that at least two decisions of the Delaware Court of Chancery had extended the *MFW* framework to other types of controlling stockholder transactions:

In re EZCORP Consulting Agreement Derivative Litigation, 2016 WL 301245 (Del. Ch. Jan. 25, 2016) and *In re Martha Stewart Living Omnimedia Stockholder Litigation*, 2017 WL 3568089 (Del. Ch. Aug. 18, 2017). Chancellor Bouchard reasoned: “I can see no principled basis on which to conclude that the dual protections in the MFW framework should apply to squeeze-out mergers but not to other forms of controller transactions. The animating principle of the MFW framework is that, if followed properly, the controlled company replicates an arm’s-length bargaining process in negotiating an executing a transaction.”

Third, the court held that Yield’s stock reclassification transaction satisfied the requirements of the MFW framework. In particular: the controller condition[ed] the procession of the transaction on the approval of both a special committee and a majority of the minority stockholders; the special committee was independent; (iii) the special committee was empowered to freely select its own advisers and to say no definitively; the special committee [met] its duty of care in negotiating a fair price; the vote of the minority was informed; and there was no coercion of the minority.

Although the plaintiff claimed that Yield’s proxy statement failed to inform its minority stockholders adequately, the court rejected those allegations as insufficient. Thus, the court applied the business judgment rule and dismissed the complaint.

Like *MFW*, *Crane* holds that employing the dual protections of an independent committee and a majority-of-the-minority stockholder vote can secure the application of the business judgment rule to conflicted transactions that require stockholder approval. *Crane* also favorably cites cases holding that both of these protections must be utilized for the business judgment rule to apply to controlling stockholder transactions that do not require shareholder approval (e.g., consulting agreements); implementing just one of the MFW protections will shift the burden of proof to the plaintiff, but it will not avoid the entire fairness test. It remains to be seen whether other cases will follow suit, requiring a special vote by a majority of the minority stockholders even for transactions that require no stockholder vote at all. Given *Crane*’s reaffirmation that it is “one of the most fundamental principles of Delaware corporate law” that directors are presumed to act independently, with due

care, in good faith, and in the best interest of stockholders, it could be reasonably argued an independent board committee’s approval should suffice to “replicate an arm’s-length bargaining process” for transactions that do not require stockholder approval. But the Delaware Supreme Court has not yet considered that argument. While that question remains open, the *Crane* decision contributes significantly to a growing consensus that proper procedural safeguards can ensure that the business judgment rule will apply beyond the merger context to any type of conflicted transaction.

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