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FLOOD V. SYNUTRA REFINES "*AB INITIO*" REQUIREMENT FOR BUSINESS JUDGMENT REVIEW OF CONTROLLER TRANSACTIONS

To Our Clients and Friends:

On October 9, 2018, in *Flood v. Synutra Int'l, Inc.*,[1] the Delaware Supreme Court further refined when in a controller transaction the procedural safeguards of *Kahn v. M & F Worldwide Corp.*[2] ("*MFW*") must be implemented to obtain business judgment rule review of the transaction. Under *MFW*, a merger with a controlling stockholder will be reviewed under the deferential business judgment rule standard, rather than the stringent entire fairness standard, if the merger is conditioned "*ab initio*" upon approval by both an independent, adequately-empowered Special Committee that fulfills its duty of care, and the uncoerced, informed vote of a majority of the minority stockholders.[3] Writing for the majority in *Synutra*, Chief Justice Strine emphasized that the objective of *MFW* and its progeny is to incentivize controlling stockholders to adopt the *MFW* procedural safeguards early in the transaction process, because those safeguards can provide minority stockholders with the greatest likelihood of receiving terms and conditions that most closely resemble those that would be available in an arms' length transaction with a non-affiliated third party. Accordingly, the Court held that "*ab initio"* (Latin for "from the beginning") requires that the *MFW* protections be in place prior to any substantive economic negotiations taking place with the target (or its board or Special Committee). The Court declined to adopt a "bright line" rule that the *MFW* procedures had to be a condition of the controller's "first offer" or other initial communication with the target about a potential transaction.

Factual Background

Synutra affirmed the Chancery Court's dismissal of claims against Liang Zhang and related entities, who controlled 63.5% of Synutra's stock. In January 2016, Zhang wrote a letter to the Synutra board proposing to take the company private, but failed to include the *MFW* procedural prerequisites of Special Committee and majority of the minority approvals in the initial bid. One week after Zhang's first letter, the board formed a Special Committee to evaluate the proposal and, one week after that, Zhang submitted a revised bid letter that included the *MFW* protections. The Special Committee declined to engage in any price negotiations until it had retained and received projections from its own investment bank, and such negotiations did not begin until seven months after Zhang's second offer.

Ab Initio Requirement

The plaintiff argued that because Zhang's initial letter did not contain the dual procedural safeguards of *MFW* as pre-conditions of any transaction, the "*ab initio*" requirement of *MFW* was not satisfied and therefore business judgment standard of review had been irreparably forfeited. The Court declined to

adopt this rigid position, and considered that "*ab initio*" for *MFW* purposes can be assessed more flexibly. To arrive at this view, the Court explored the meaning of "the beginning" as used in ordinary language to denote an early period rather than a fixed point in time. The Court also parsed potential ambiguities in the language of the Chancery Court's *MFW* opinion, which provided that *MFW* pre-conditions must be in place "from the time of the controller's first overture"[4] and "from inception."[5]

Ultimately, the Court looked to the purpose of the *MFW* protections to find that "*ab initio"* need not be read as referring to the single moment of a controller's first offer. As *Synutra* emphasizes, the key is that the controller not be able to trade adherence to *MFW* protections for a concession on price. Hence the "*ab initio*" analysis focuses on whether deal economics remain untainted by controller coercion, so that the transaction can approximate an arms' length transaction process with an unaffiliated third party. As such, the Court's reasoning is consistent with the standard espoused by the Chancery Court in its prior decision in *Swomley v. Schlecht,*[6] which the Court summarily affirmed in 2015, that *MFW* requires procedural protections be in place prior to the commencement of negotiations.[7]

In a lengthy dissent, Justice Valihura opined that the "*ab initio*" requirement should be deemed satisfied only when *MFW* safeguards are included in the controller's initial formal written proposal, and that the "negotiations" test undesirably introduces the potential for a fact-intensive inquiry that would complicate a pleadings-stage decision on what standard of review should be applied. Chief Justice Strine acknowledged the potential appeal of a bright line test but ultimately rejected it because of the Court's desire to provide strong incentive and opportunity for controllers to adopt and adhere to the *MFW* procedural safeguards, for the benefit of minority stockholders. In doing so, the Court acknowledged that its approach "may give rise to close cases." However, the Court went on to add, "our Chancery Court is expert in the adjudication of corporate law cases." The Court also concluded that the facts in *Synutra* did not make it a close case.[8]

Duty of Care

The Court also upheld the Chancery Court's dismissal of plaintiff's claim that the Special Committee had breached its duty of care by failing to obtain a sufficient price. Following the Chancery Court's reasoning in *Swomley*, *Synutra* held that where the procedural safeguards of *MFW* have been observed, there is no duty of care breach at issue where a plaintiff alleges that a Special Committee could have negotiated differently or perhaps obtained a better price – what the Chancery Court in *Swomley* described as "a matter of strategy and tactics that's debatable."[9] Instead, the Court confirmed that a duty of care violation would require a finding that the Special Committee had acted in a grossly negligent fashion. Observing that the Synutra Special Committee had retained qualified and independent financial and legal advisors and engaged in a lengthy negotiation and deal process, the Court found nothing to support an inference of gross negligence and thus deferred to the Special Committee regarding deal price.[10]

Procedural Posture

Synutra dismissed the plaintiff's complaint at the pleadings stage. In its procedural posture, the Court followed *Swomley*, which allowed courts to resolve the *MFW* analysis based on the pleadings. The

dissent noted that adoption of a bright-line test would be more appropriate for pleadings-stage dismissals. However, the Court established that it would be willing to engage some degree of fact-finding at the pleadings stage in order to allow cases to be dismissed at the earliest opportunity, even using the Court's admittedly more flexible view of the application of *MFW*.

Takeaways

Synutra reaffirms the Court's commitment to promoting implementation of *MFW* safeguards in controller transactions. In particular:

- The Court will favor a pragmatic, flexible approach to "*ab initio*" determination, with the intent of determining whether the application of the *MFW* procedural safeguards have been used to affect or influence a transaction's economics;
- Once a transaction has business judgment rule review, the Court will not inquire further as to sufficiency of price or terms absent egregious or reckless conduct by a Special Committee; and
- Since the goal is to incentivize the controller to follow *MFW* at a transaction's earliest stages, complaints can be dismissed on the pleadings, thus avoiding far more costly and time consuming summary judgment motions.

Although under *Synutra* a transaction may receive business judgment rule review despite unintentional or premature controller communications that do not reference the *MFW* procedural safeguards as inherent deal pre-conditions, deal professionals would be well advised not to push this flexibility too far. Of course, there can be situations where a controller concludes that deal execution risks or burdens attendant to observance of the *MFW* safeguards are too great (or simply not feasible), and thus is willing to confront the close scrutiny of an entire fairness review if a deal is later challenged. However, if a controller wants to ensure it will receive the benefit of business judgment rule review, the prudent course is to indicate, in any expression of interest, no matter how early or informal, that adherence to *MFW* procedural safeguards is a pre-condition to any transaction. *Synutra* makes clear that the availability of business judgment review under *MFW* will be a facts and circumstances assessment, but we do not yet know what the outer limits of the Court's flexibility will be, should it have to consider a more contentious set of facts in the future.

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[1] *Flood v. Synutra Int'l, Inc.*, No. 101, 2018 WL 4869248 (Del. Oct. 9, 2018).

[2] *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

[3] *Id*. at 644.

[4] *In re MFW Shareholders Litigation*, 67 A.3d 496, 503 (Del. Ch. 2013).

[5] *Id*. at 528.

[6] *Swomley v. Schlecht*, 2014 WL 4470947 (Del. Ch. 2014), *aff'd* 128 A.3d 992 (Del. 2015) (TABLE).

[7] The Court did not consider that certain matters that transpired between Zhang's first and second offer letters, namely Synutra's granting of a conflict waiver to allow its long-time counsel to represent Zhang (the Special Committee subsequently hired separate counsel), constituted substantive "negotiations" for this purpose since the waiver was not exchanged for any economic consideration.

[8] *Synutra*, 2018 WL 4869248, at *8.

[9] *Id.* at *11, citing *Swomley*, 2014 WL 4470947, at 21.

[10] In a footnote, the Court expressly overruled dicta in its *MFW* decision that the plaintiff cited to argue that a duty of care claim could be premised on the Special Committee's obtaining of an allegedly insufficient price. *Id.* at *10, Footnote 81.

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