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Corporate Litigation

Business Judgment Rule Applies to Shareholder Suits Challenging Going-Private Mergers in New York

Action Item: New York's High court provides a road map of how corporate attorneys should structure going-private transactions involving controlling shareholders. Utilizing certain protective measures at the outset should ensure the application of the business judgment rule and result in dismissal of minority shareholders' breach of fiduciary duty claims.

On May 5, 2016, in *In re Kenneth Cole Productions Shareholder Litig.,* Case No. 54, Apl. No. 2015-00155 (N.Y.), the New York Court of Appeals rejected a challenge by minority shareholders of Kenneth Cole Productions, Inc. ("KCP") to controlling shareholder Kenneth Cole's transaction that took KCP private. In so doing, the court conformed New York corporations law to that of Delaware, and held that the deferential "business judgment" rule—and not the rigorous "entire fairness" test—is the proper standard to be applied by New York courts in reviewing challenges to going-private mergers, so long as several enumerated shareholder-protections existed. This important case of first impression provides a road map on what counsel should do in order to ensure dismissal of minority shareholder challenges.

Background

In February 2012, Mr. Cole, who owned 46% of KCP's Class A shares and all of its Class B shares, offered to purchase the remaining Class A shares and take KCP private. The board established a special committee of four independent directors to negotiate the proposal. Mr. Cole's initial offer of $15.00 per share was conditioned on approval by the special committee and a majority of the minority shareholders. Mr. Cole indicated that he was not interested in selling his shares to a third party. After months of negotiations, the offer was raised to $15.25 per share. The special committee approved and recommended the merger to the minority shareholders—who overwhelmingly approved the transaction. Several class actions were filed by minority shareholders alleging breach of fiduciary duty by Mr. Cole and the directors. The plaintiffs, *inter alia,* alleged that the directors agreed to an unfair price and that Mr. Cole breached his fiduciary duties by bargaining to pay as little as possible while foreclosing the possibility of a third-party transaction. Attempting to block the transaction, the plaintiffs urged the courts to apply the fact-intensive entire fairness standard—which would place the burden on the directors to demonstrate that they engaged in a fair process and obtained a fair price. The trial court instead applied the business judgment rule and dismissed the plaintiffs' claims. The Appellate Division First Department affirmed. The issue before the Court of Appeals was "what standard should be applied by courts reviewing a going-private merger that is subject from the outset to approval by both a special committee of independent directors and a majority of the minority shareholders." Adopting the Delaware Supreme Court's holding in *Kahn v M & F Worldwide Corp.,* 88 A3d 635 (Del. 2014), the court held that the business judgment rule should apply so long as the corporation's directors satisfied six shareholder-protective conditions: (i) the controller conditions the procession of the transaction on the approval of both a special committee and 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. The court explained, however, that if any of these protections were not in place, then the business judgment rule was inapplicable and the entire fairness standard should apply. In dismissing the action, the court concluded that the plaintiffs failed to allege that any of the conditions were absent from the KCP merger.

Conclusion

In re Kenneth Cole Productions provides valuable instructions on how corporate attorneys should structure going-private transactions involving controlling shareholders from the outset. New York's high court has made clear that the inclusion of appropriate protections for minority stockholders should cloak directors with the protection of the business judgment rule. The holding suggests that best practice should entail, (1) an independent special committee formulating the terms of the transaction, and (2) the transaction being approved by a fully informed majority of the minority shareholders. Doing so should withstand breach of fiduciary duty claims under New York law at the motion to dismiss stage.

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