The Harvard Law School Forum on Corporate Governance and Financial Regulation
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New York Appeals Court Applies Business Judgment Rule to Going Private Transaction

Posted by Yaron Nili, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Wednesday November 26, 2014

Editor's Note: The following post comes to us from Tariq Mundiya, partner in the litigation department of Willkie Farr & Gallagher LLP, and is based on a Willkie client memorandum by Mr. Mundiya, Sameer Advani, and Benjamin McCallen.

On November 20, 2014, the New York Appellate Division, First Department, in a case of first impression under New York law, ruled in favor of Kenneth Cole in a litigation where minority shareholders had challenged the fashion designer's transaction to take private Kenneth Cole Productions, Inc. Mr. Cole controlled approximately 89% of KCP's voting power and owned a 46% economic interest in KCP. Willkie Farr & Gallagher LLP represented Mr. Cole in the transaction and the class action litigation.

The Appellate Division found that the business judgment standard of review—and not the heightened entire fairness standard—applied to judicial review of breach of fiduciary claims because the transaction had been structured at the outset with dual protections of an independent special committee review and the vote of a "majority of the minority" (that is, non-Cole) shareholders. The judicial standard of review can have important litigation consequences, as cases governed by the business judgment rule can be dismissed at an early stage, as occurred here, whereas transactions governed by the "entire fairness" standard generally require discovery and further proceedings, which can be burdensome and expensive.

Factual Background

On February 24, 2012, KCP announced that Mr. Cole had proposed a transaction to take KCP private and to pay the public stockholders $15.00 per share, which reflected a 17% premium to KCP's unaffected share price. KCP's board created a special committee of four independent directors to negotiate with Mr. Cole, who conditioned his bid on the approval of the special committee and the affirmative vote of a majority of the minority stockholders. Mr. Cole made it publicly clear that he would not entertain any offers to sell his shares in a third-party transaction and was only interested in buying shares from the minority stockholders. After several months of negotiations, Mr. Cole agreed to pay $15.25 per share. 99.8% of KCP's shares unaffiliated with Mr. Cole that voted ultimately voted in favor of the transaction.

Plaintiffs, on behalf of a putative class of KCP minority stockholders, filed lawsuits alleging that the KCP directors breached their fiduciary duties by agreeing to a price that was unfair to the minority stockholders and had resulted from an unfair process because, among other things, the special committee was not truly independent. The stockholders further claimed that Mr. Cole breached his fiduciary duties because he had bargained hard with the special committee to pay as little as possible and had announced that he was unwilling to sell his shares to a third party, thus negatively impacting the value that the minority stockholders could receive for their shares.

The Trial Court's Ruling

The trial court dismissed the complaint against all defendants. Although the issue of what standard of review should apply to the board's decision was extensively briefed by all sides, the trial court did not squarely address whether the "entire fairness" standard applied and simply applied the business judgment rule to the board's decision to recommend and approve the transaction. The trial court ultimately dismissed the complaint because it found that the allegations for breach of fiduciary duty against Mr. Cole simply amounted to a claim that the controlling stockholder had acted in his own economic interest, which was not sufficient to state a claim. As to the director defendants, the trial court confirmed that special committees are not required to engage in futile acts and the special committee did not breach its fiduciary duties by failing to solicit other offers because it was clear that Mr. Cole would reject them (as he was entitled to do).

Applying the business judgment rule, the trial court concluded that "even assuming that a higher price might have been possible, that does not render the special committee's actions a violation of their fiduciary duties. At most, plaintiffs have alleged that they disagree with the manner in which the special committee pursued negotiations with Cole and are dissatisfied with the result. However, such dissatisfaction does not suggest that the process was unfair or demonstrate that a duty of trust was violated…." The trial court reiterated that "absent a showing of specific unfair conduct by the special committee, the Court will not second guess the committee's business decisions in negotiating the terms of a transaction."

The Appellate Division Ruling

The central question on appeal was whether the trial court correctly applied the business judgment rule to the defendants' actions. Affirming the trial court's dismissal of the complaint against all defendants (including Mr. Cole and KCP's directors), the Court found that "the motion court was not required to apply the 'entire fairness' standard to the transaction[.]" Rather, it was appropriate to apply the business judgment standard of review. Applying that standard, the Appellate Division affirmed the trial court's finding that plaintiffs had failed to allege facts supporting a claim that Mr. Cole or the independent directors had breached their fiduciary duties. In so holding, the Appellate Division distinguished the New York Court of Appeals' decision in *Alpert v. 28 Williams St. Corp.*, 63 N.Y.2d 557 (1984), which had applied the entire fairness standard to a freeze out merger. The Appellate Division noted that Mr. Cole's going-private transaction, unlike the transaction at issue in *Alpert*, "required approval of the majority of the minority (*i.e.*, non-Cole) shareholders."

The Appellate Division's decision in *Kenneth Cole* puts New York law in line with recent Delaware law. In *Kahn v. M&F Worldwide*, 88 A.3d 607 (Del. 2014), the Delaware Supreme Court recently held that the business judgment rule would apply to judicial review of a going-private transaction that is approved by a fully empowered independent special committee and a fully informed vote of a majority-of-the-minority stockholders. As the *M&F Worldwide* court held, such protections result in a going private transaction closely resembling a third party arms' length deal.

The *Kenneth Cole* decision makes clear that properly structuring a going-private transaction at the outset—including with appropriate protections for minority stockholders—can be critical in ensuring that such transactions receive business judgment rule protection in subsequent litigation. That can result in the dismissal of litigation at the pleadings stage, before the burdens of discovery.