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Another Road Leading to Business Judgment Review—Martha Stewart Living Omnimedia

Posted by Gail Weinstein & Steven Epstein, Fried, Frank, Harris, Shriver & Jacobson LLP, on Wednesday, September 6, 2017

Editor's note: Gail Weinstein is senior counsel and Steven Epstein is a partner at Fried, Frank, Harris, Shriver & Jacobson LLP. This post is based on a Fried Frank publication by Ms. Weinstein, Mr. Epstein, Philip Richter, and Scott Luftglass. This post is part of the Delaware law series; links to other posts in the series are available here.

In *In re Martha Stewart Living Omnimedia Inc. Stockholder Litigation* (Aug. 18, 2017), the Delaware Court of Chancery dismissed claims made by former stockholders of Martha Stewart Living Omnimedia ("MSLO" or the "Company") against the Company's former controlling stockholder, Martha Stewart, for alleged breaches of her fiduciary duties in connection with the 2015 sale of the Company to third party buyer Sequential Brands, Inc. The lawsuit alleged that, although Stewart received the same merger consideration as the other stockholders for her shares, she had leveraged her position as the controlling stockholder of the Company to secure greater consideration for herself through "side deals" with the buyer.

Although the stringent entire fairness test is the default standard of review for challenges to conflicted controller transactions, the court held that the side deals did *not* render Stewart a "conflicted" controller and, therefore, that the business judgment rule applied. Further, the court stated, even if the side deals *had* rendered Stewart "conflicted," the procedural protections that were provided to the minority stockholders would have lowered the standard of review to business judgment in any event under *MFW*.

Key Points

- **The decision indicates that the court will extend *MFW*'s reach to apply to a "*one*-sided" controller transaction in which the controller was conflicted.** *MFW* has provided a roadmap for business judgment review of "two-sided" controller transactions—*i.e.*, transactions where the controller is buying the company it controls and is "conflicted" because it "stands on both sides of the transaction." In *Martha Stewart*, the court, in *dicta*, extended the roadmap for *MFW* protection to "one-sided" conflicted controller transactions—*i.e.*, transactions where the controller is selling its shares in a third party acquisition of the company it controls and the controller is conflicted because it is obtaining a benefit that is not shared pro rata by the other shareholders.
- **The court stated that, to obtain business judgment review under *MFW* in the context of a one-sided conflicted controller transaction, the *MFW*-prescribed protections would have to be in place only before negotiations commenced between the controller and the buyer about the controller's special arrangements—**

not, as *MFW* has required (in two-sided controller transactions), before merger negotiations commenced between the buyer and the target company.

- **The court held that the "side deals" between the controller and the buyer did *not* render the controller "conflicted" in this case because they essentially replicated the controller's pre-merger arrangements with the company.** The decision indicates that the "character and nature" of side deals will determine whether they do or do not render a controller conflicted. In this case, the court found that the side deals did not render the controller conflicted because they were not "meaningfully different" from the arrangements the controller had with the company pre-merger. Therefore, the court concluded, the side deals could not be said to have "diverted merger consideration from the other stockholders to the controller." The court held that business judgment review therefore applied in this case whether or not *MFW* applied (because there was not a conflicted controller).

Background

The Company had formed a special committee comprised entirely of independent directors to review an indication of interest received by a third party. After discussions with that party were terminated, Sequential indicated an interest in acquiring the Company. Shortly after beginning discussions with the special committee, Sequential stated that, before continuing with the discussions, it wanted to negotiate post-closing arrangements with Martha Stewart, who was the controlling stockholder, the Creative Director, and "the face of the Company"—and who had pre-existing contractual arrangements with the Company relating to employment, intellectual property and expense reimbursement. Sequential explained that, before expending the time and resources necessary to negotiate a transaction, it wanted to ascertain whether it would be able to reach agreement with Stewart about her post-closing role. The committee agreed, while reserving the right to evaluate any arrangements with Stewart before approving a merger.

The day before Stewart began her separate negotiations with Sequential, Sequential stated that the merger would be conditioned on approval by a majority of the shares not owned by Stewart or her affiliates. Sequential then negotiated an employment agreement and registration rights agreement with Stewart, an extension of some of her intellectual property agreements with the Company, and an agreement to reimburse her for up to $4 million in fees incurred in connection with her negotiations relating to the merger (referred to collectively as Stewart's "side deals"). Concurrently, Sequential negotiated a merger agreement with the committee.

The committee, which had engaged independent advisors and was fully authorized by the board to consider all strategic alternatives, obtained a fairness opinion, reviewed Stewart's side deals, and approved the merger agreement. The merger agreement provided for a 30-day post-signing go-shop period; matching rights for Sequential; a termination fee of $7.8 million (about 2%) during the go-shop period, which would increase to $12.8 million (about 3.6%) after that period; and a non-waivable condition that the merger be approved by a majority of the shares not affiliated with Stewart. 99% of the shares that were not affiliated with Stewart voted in favor of the merger.

After the merger closed, the plaintiffs brought suit, alleging that Stewart had used her leverage as the controlling stockholder to negotiate the side deals, which, they contended, had diverted merger consideration from the other stockholders to Stewart. Given that Stewart was therefore a "conflicted controller," they argued, "entire fairness" review was applicable. Vice Chancellor

Slights dismissed the case after finding that the side deals did not cause Stewart to be conflicted and that therefore business judgment review applied, requiring dismissal. Further, he stated in *dicta* that, even if the side deals *had* caused Stewart to be conflicted, business judgment review would have applied anyway under *MFW* given that, from the outset of Stewart's negotiations with Sequential about her side deals, the merger was subject to approval by an independent committee and the minority stockholders.

Discussion

"Entire fairness" is the default standard of review for "conflicted" controller transactions. A controller is "conflicted" when (i) it is the buyer of the company it controls and so "stands on both sides of the transaction" (a "two-sided transaction"); or (ii) it is one of the shareholders selling shares in a third party acquisition of the company (a "one-sided transaction") but also obtains (a) a different price per share in the merger than is paid to the other shareholders and/or (b) a "unique benefit" not shared pro rata with the other stockholders. In these conflicted controller situations, the default standard of review is entire fairness.

***MFW* provides a roadmap to business judgment review for conflicted controller transactions.** Under *MFW*, the deferential business judgment rule will apply instead of entire fairness when, in a two-sided controller transaction, the controller put into place, from the outset of negotiations with the company, the *MFW*-prescribed procedural protections for the minority stockholders—namely, that the merger is subject to approval by both (i) an independent special committee that is fully-empowered and well-functioning and (ii) a majority of the outstanding shares not affiliated with the controller in a fully-informed and uncoerced vote. (It has continued to be the case, as pre-*MFW*, that, if only one of these protections is in place, business judgment review does not apply but the burden of proof with respect to entire fairness will shift from the defendants to the plaintiffs.)

In *Martha Stewart*, the court stated, *in dicta*, that the *MFW* roadmap is applicable also to "*one-sided*" conflicted controller transactions. Although a controller is *always* conflicted in a two-sided transaction (because it stands on both sides of the transaction), a controller is not conflicted in a one-sided transaction as a general matter (because its interests as a seller of shares are aligned with the interests of the other stockholders). However, a controller may become conflicted in a one-sided transaction *if* the controller obtains a higher merger price per share than, or some other benefit not shared pro rata by, the other stockholders. The court stated that the *MFW* roadmap to business judgment review applies not only in the case of a two-sided transaction but also in the case of a conflicted controller in a one-sided transaction. The effect of the decision is that business judgment review would apply to any conflicted controller transaction if the transaction is *MFW*-compliant.

The decision highlights that not all "side deals" with a controller will render the controller conflicted. The court determined that the "nature and character" of Stewart's side deals indicated that she had *not* been a "conflicted" controller—as the side deals essentially only replicated the pre-merger arrangements she had had with the Company and, therefore, "had not diverted consideration from the minority stockholders to [her]." First, the court reasoned, since Sequential had *increased* its offer after completing its negotiations with Stewart, it was not reasonably conceivable that consideration had been diverted from the minority stockholders into the side deals. Further, and more importantly in our view, the court stated, the plaintiffs failed to

distinguish the "new" side deals as being "meaningfully different" from the "old" side deals that Stewart had in place with the Company pre-merger. The new side deals "to reasonable degrees tracked the structure, value and obligations of the side deals [Stewart] had in place before the Merger," the court stated. The court commented further that: "[Stewart] herself was a stockholder who had by far the largest stake in the Merger consideration"; "Sequential was acquiring the Martha Stewart brand and, in part, the continued commitment of Martha Stewart's time, energy and talent to keep the brand alive and thriving, [therefore,] it was entirely proper for Sequential to pay, and for Stewart to accept, extra consideration (just as [the Company] had paid before the Merger) to secure the immeasurable value of that commitment"; and "[i]ndeed, these fair value side deals ultimately facilitated the Merger and enabled stockholders to realize premium value for their shares." It is unclear whether the sole test for whether side deals divert consideration from the minority stockholders to a controller is whether they were materially equivalent to past arrangements that the controller had with the company, or whether, in addition (or, possibly, instead) the test is whether there was an appropriate corporate purpose for the side deals (as, for example, if the buyer believed that the side deal was necessary to obtain needed services from the controller).

Even if the controller *had* been conflicted, the court stated, the minority protections that were provided would have lowered the standard of review to the business judgment rule under *MFW*. In indicating that *MFW* would apply in a one-sided conflicted controller situation, the court reasoned that "[t]he conflicts inherent in the disparate consideration scenario [of a one-sided transaction] are no more or less present or worrisome than in the scenario where the controller stands on both sides of the transaction [in a two-sided transaction]…. The need to incentivize fiduciaries to act in the best interests of the minority stockholders, likewise, is equally important in one-sided and two-sided conflicted controller transactions. In both instances, the key is to ensure that all involved in the transaction, on both sides, 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." (We note that, by contrast, *when MFW applies* to a one-sided conflicted controller transaction, business judgment review should apply *without regard* to the nature of the side deals).

The court rejected the plaintiffs' argument that business judgment review could not apply under *MFW* because the minority stockholder protections were not in place *when the merger negotiations commenced*. Under *MFW*, to obtain business judgment review, the prescribed protections must be in place before the merger negotiations commence between the buyer and the target company. In *Martha Stewart*, the majority-of-the-minority vote condition was not put into place until after the merger negotiations began. The court concluded that, in the case of a *one-sided* controller transaction, the *MFW* protections must be in place before the negotiations begin *between the controller and the buyer about the controller's special arrangements*. The court explained: "Unlike the case in a two-sided controller transaction, where the controller has the ability publicly to announce that it is conditioning any transaction on the [*MFW*] procedural protections in its initial offer to the board of the target," in a one-sided controller transaction, "where an unaffiliated third party initiates the process with its offer, the controller obviously has no control over the conditions the third party will impose on the process or approval of the transaction." In a one-sided situation, if the protections are in place before "the controlling stockholder actually sits down with an acquiror to negotiate for additional consideration," then "all actors, and most importantly the controlling stockholder, enter those negotiations aware that both

the Special Committee and the majority of the minority stockholders will have the final say on whether the deal, with the controller's extra consideration, will be approved."

The court indicated that the process implemented by Sequential and the committee satisfied the *MFW* framework.

- ***The court easily dismissed the plaintiffs' claims that the committee directors were not independent.*** These claims were based on the directors allegedly being "beholden" to Stewart by reason of current or previous business relationships, social ties and/or her controller status. The court emphasized that such relationships and ties impugn independence only when they are "material," meaning that they are "sufficiently substantial that [the director] could not objectively discharge his or her fiduciary duties."
- ***The court found that the plaintiffs had not stated a valid claim that the committee had not functioned effectively.*** The plaintiffs alleged that the committee retained a financial advisor who "[was] conflicted and who, in fact, controlled the negotiations, permitted Stewart to dictate a 'targeted search' for a buyer rather than an auction, permitted Stewart to meet with Sequential to discuss the merits of a transaction before commencing negotiations on its own, permitted Stewart to negotiate her agreements with Sequential while deferring any discussion of price for the Company, declined even to entertain a third party offer for [the Company] after Stewart had completed negotiations on her arrangements, and…deferred to Stewart's position that she was not going to alter [an expense reimbursement arrangement she had agreed with the buyer]." One basis for the conflict claim was that the CEO-director of the Company, who was also "a loyal friend of Stewart's," had, at another company, "worked alongside" one of the advisor's managing directors. The court stated that a relationship between an advisor and a member of the board of the company it is advising generally raises no conflict concern; that no such concern arose here based on the director being "a Stewart loyalist"; and that, in any event, the advisor was representing the special committee, not the full board, and the director at issue was not even a member of the committee (nor were there allegations that he had somehow interfered with the committee's work). Another basis for the conflict claims was that the advisor had previously performed services for Sequential's second largest stockholder. The court stated that an advisor's prior dealings with a counterparty to the proposed transaction does not itself indicate a conflict. The court noted that the allegation in this case was not even that the advisor did work for Sequential but involved a more remote relationship (as the work was for an affiliate of a stockholder of Sequential). The court also noted that the advisor had received customary compensation for that work.
- The plaintiffs also alleged that the committee had not performed its duties effectively. The court stated that the plaintiffs' "vague criticisms of the [c]ommittee's process and decision-making land[edh] far wide of the mark set by [*MFW*]." The measure of effectiveness of a committee under *MFW* is whether the committee breached its duty of care—that is, whether the committee had been "grossly negligent," which, as the court stated, entails "reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason." According to the court, the plaintiffs did "nothing more than question the business judgment of the independent committee members, an avenue of attack this court has repeatedly rejected." The court reviewed that the committee had met frequently over a period of several months; rejected an earlier offer from another company when the Company's financial condition had

improved and that other company was unwilling to raise its offer price; allowed Stewart to negotiate with Sequential concurrently only after Sequential committed that the deal would be subject to a majority-of-the-minority vote; and negotiated "vigorously" with Sequential on price and ultimately secured a post-signing go-shop period despite Sequential's initial reluctance to agree to this term. "And, importantly," the court wrote, "[the committee] was able to get Sequential to better its final offer even though [there was a negative business development] and even after Sequential had reached an agreement with Stewart on her post-closing contractual arrangements."

Practice Points

- **Legal and deal risks in conflicted controller transactions.** The legal risk relating to a potential post-closing challenge to a transaction is lowest when the business judgment rule applies, as business judgment review typically leads to dismissal of the case at an early stage of litigation. Legal risk is heightened when the entire fairness standard of review applies, as entire fairness review requires an intensive judicial inquiry into the facts and circumstances to determine whether the transaction price and the transaction process were fair. Thus, making a transaction *MFW*-compliant (which leads to the business judgment rule standard) increases the *legal certainty* for a transaction— however, it also may heighten the *deal risk* because, for *MFW* to apply, the transaction must be subject to approval by a special committee and majority-of-the-minority vote. Accordingly:
    - ***In a two-sided transaction that is not MFW-compliant,*** there would be greater legal risk (because entire fairness would apply) but also less deal risk (because the deal would not be subject to the *MFW*-prescribed approvals).
    - ***In a two-sided transaction that is MFW-compliant,*** there would be decreased legal risk (because the business judgment rule would apply) but also increased deal risk (because the deal would be subject to the *MFW*-prescribed approvals).
    - ***In a one-sided transaction in which the controller receives no special benefit,*** there would be decreased legal risk and deal risk (because business judgment would apply without the deal having to be *MFW*-compliant).
    - ***In a one-sided transaction in which the controller receives a special benefit, if the transaction is MFW-compliant,*** there should be decreased legal risk (because, based on *Martha Stewart*, the business judgment rule should apply) but also increased deal risk (because the deal would be subject to the *MFW*-prescribed approvals).
    - ***In a one-sided transaction in which the controller receives a special benefit, if the transaction is not MFW-compliant,*** there would be decreased deal risk (because the deal would not be subject to the *MFW*-prescribed approvals) but also increased legal risk— because it would be uncertain whether the court would or would not deem the special benefit to have diverted merger consideration from the minority stockholders to the controller. If the benefit is viewed as having diverted consideration from the minority stockholders, then the controller would be deemed to be "conflicted." If the controller is deemed to be conflicted, then entire fairness would apply. If the controller is *not* deemed to be conflicted, then business judgment review would apply. *The determination as to whether a controller was or was not conflicted will be heavily dependent on the facts and circumstances, as well as development of the legal standard for*

evaluating controller side deals. The relevant factors could include, for example, the value of the benefit received, whether the benefit replicated a benefit that the controller had pre-merger, whether the value to the buyer of any such benefit (pre-merger and/or post-merger) was appropriate, the purpose of the benefit (for example, whether the third party buyer believed that it was necessary to obtain the services of the controller), and/or whether there is any indication that the controller used its leverage to divert merger consideration from the minority stockholders.

- **Risks associated with a majority-of-the-minority vote.** Including a majority-of-the-minority approval requirement may in certain circumstances provide activist shareholders with leverage to seek to obtain hold-up value in connection with the transaction, as after announcement of the deal they can acquire shares and defeat majority-of-the-minority approval (as, for example, occurred in the first form of the *Dell* going private transaction).
- **The role of appraisal.** We note that, even if *MFW* applies to a transaction and there is no legal uncertainty with respect to post-closing challenges, the buyer still may face the uncertainty that stockholders may seek appraisal. Notably, however, any appraisal award is payable only to the stockholders who did not vote for the merger and filed appraisal claims (whereas, if the court orders a higher price to be paid based on an entire fairness review, the higher price is paid to all stockholders).
- **What is required for the court to view a controller's "side deals" entered into in connection with a third party merger as not creating a conflict for the controller with respect to the merger?** In *Martha Stewart*, as discussed, the court focused on whether the side deals "diverted merger consideration from the minority stockholders to the controller." The court found that Stewart's side deals had not diverted merger consideration because they simply replicated her pre-merger arrangements with the company. The court also emphasized that the arrangements appeared to fulfill an appropriate corporate purpose of the buyer. We note that the fact in and of itself that side deals replicate pre-merger arrangements would appear to be not critical so long as what the buyer is obtaining in the side deals reflects an appropriate benefit to the company.
- **Timing for *MFW* protections.** We note that to obtain *MFW* protection in a one-sided controller situation involving side deals for the controller, the *buyer* is the party that would have to act— before the controller and the buyer commence negotiations about the side deals—to condition the transaction on approval by a special committee and a majority of the minority stockholders.