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DE Case Summaries

In re Martha Stewart Living Omnimedia, Inc. S'holder Litig., C.A. No. 11202-VCS (Aug. 18, 2017) (Slights, V.C.)

08.18.2017

In this decision, the Court of Chancery dismissed a challenge to a third-party merger transaction in which it was alleged that a controller received disparate consideration, holding that the plaintiffs failed to adequately allege a basis to infer that the controller's "side deals" with the buyer diverted consideration that otherwise would have been available to the minority stockholders. The Court also elaborated on the Supreme Court's decision in *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014), which detailed the procedural protections a controller must employ to obtain business judgment review of a conflicted controller transaction at the pleadings stage. Specifically, the Court determined that the procedural protections described in *M & F Worldwide* were implemented *ab initio*, in this context, because the protections were established before the controller began negotiating for any disparate consideration or unique benefit.

The plaintiffs challenged a merger (the "Merger") by which Sequential Brands Group, Inc. and certain of its affiliates ("Sequential") acquired Martha Stewart Living Omnimedia, Inc. ("MSLO" or the "Company"). According to the complaint, Martha Stewart was the controlling stockholder of the Company. Before the Merger, Stewart and MSLO were parties to a series of employment and intellectual property agreements (collectively, the "Pre-Merger Agreements"), which governed the terms on which Stewart worked for the Company and licensed certain of her intellectual property. Several of those agreements were set to expire in 2017.

In the summer of 2014, the board of MSLO formed a special committee of independent directors to explore, evaluate, and negotiate strategic alternatives (the "Special Committee"). By the spring of 2015, the Special Committee began negotiating a merger with Sequential, and on May 11, 2015, Sequential submitted a bid conditioned upon approval of the transaction by a majority of MSLO's minority stockholders. The Special Committee met the next day to evaluate the revised proposal and at that time was informed of Sequential's desire to negotiate with Stewart concurrently regarding her post-closing employment and intellectual property arrangements. In response to Sequential's request, the Special Committee permitted Stewart to begin negotiating her post-closing arrangements. Thereafter, Sequential increased its bid, and on June 22, 2015, the parties signed a merger agreement at a price of $6.15 per share. The Merger was approved by approximately 99% of the stockholders who voted.

Concurrently with signing the merger agreement, the parties executed a series of agreements to govern Stewart's employment and intellectual property licenses after closing (the "Post-Merger Agreements"). Compared to the Pre-Merger Agreements, the Court found the most pertinent changes were: (1) the agreements that were set to expire in 2017 were extended until 2020, and Stewart's employment would extend another five years upon certain conditions; (2) Stewart became entitled to certain licensing revenues under certain conditions; (3) Stewart received a registration rights agreement; (4) if Stewart were terminated, she would not be permitted to use her name in new businesses as she would have been under the Pre-Merger Agreements; and (5) Stewart became entitled to reimbursement of up to $4 million for expenses incurred in negotiating the Post-Merger Agreements.

The plaintiffs filed suit against Stewart and Sequential, alleging that: (1) Stewart breached her fiduciary duties by obtaining separate benefits from the Post-Merger Agreements that detracted from the consideration paid to the minority stockholders; and (2) Sequential aided and abetted Stewart's breaches. The defendants filed motions to dismiss, and in an August 18, 2017 opinion, the Court granted those motions.

The Court first ruled that the plaintiffs failed to allege a basis to apply entire fairness review to the Merger. The plaintiffs argued, notwithstanding that Stewart received the same $6.15 per share as the minority stockholders as consideration in the Merger, that the purported new benefits procured in connection with the Post-Merger Agreements diverted consideration from the minority to Stewart's benefit, triggering entire fairness review. The plaintiffs' theory relied on their allegation that Sequential decreased its offer following the beginning of negotiations regarding the Post-Merger Agreements, but the Court rejected that allegation, explaining that it was inconsistent with the chronology described in the proxy statement issued in connection with the minority vote on the Merger (the "Proxy"), which the plaintiffs relied upon as the source of their factual allegations. According to the Proxy, Sequential's bid increased following the initiation of negotiations regarding the Post-Merger Agreements. On those facts, the Court found, it was not reasonably conceivable that Stewart caused Sequential to divert consideration that otherwise would have been available to the minority stockholders.

The Court also found that the plaintiffs failed to plead non-conclusory facts that demonstrated that the Post-Merger Agreements were sufficiently better than the Pre-Merger Agreements to support a diverted consideration claim. The Court found that the Post-Merger Agreements "to reasonable degrees tracked the structure, value and obligations" of the Pre-Merger Agreements and noted that Sequential, not Stewart, initiated negotiations regarding the modifications to those agreements to ensure that Stewart would remain committed to supporting the "Martha Stewart brand" that Sequential was acquiring. For this reason as well, the Court found that the well-pleaded allegations in the complaint failed to support the theory that the changes to the Post-Merger Agreements diverted consideration to Stewart.

The Court then elaborated that even had the plaintiffs adequately alleged a controller conflict, the business judgment rule would apply at the pleadings stage because of the presence *ab initio* of the dual procedural protections described in *M & F Worldwide* (*i.e.*, approval by both the minority stockholders and a well-functioning and unconflicted special committee). As a preliminary matter, the Court expressed its view that the dual protections described in *M & F Worldwide* can apply to trigger business judgment review at the pleadings stage of cases challenging third-party buyouts of controlled companies in which the controller received disparate consideration or a unique benefit, reasoning that two previous Court of Chancery decisions had held at the summary judgment stage that the dual protections can cleanse such transactions, and that *M & F Worldwide* subsequently provided the "road map" to obtain dismissal at the pleadings stage based on those protections. The Court then addressed the *ab initio* requirement, noting that previous decisions evaluating the efficacy of the dual protections in third-party transactions had not commented on the timing requirement noted in *M & F Worldwide*. In this context, the Court noted that the *ab initio* condition requires that the dual protections be established before the controller begins negotiating for disparate consideration or a unique benefit. The Court explained that, unlike in two-sided controller transactions where the controller initiates negotiations by proposing a minority buyout and can impose the dual protections upfront, in one-sided controller transactions, the controller has no control over the conditions a third party may impose on the approval of the transaction until it begins negotiating with the third party. Further, unlike in controller buyouts, the conflict of interest in third-party transactions does not arise at the outset of negotiations between the company and the third party; rather, the conflict in third-party transactions arises only if and when the controller seeks a premium that detracts from the consideration paid to the minority. In this case, Stewart did not begin negotiating her Post-Merger Agreements with Sequential until after the Special Committee was formed and after Sequential delivered a proposal contingent on a majority-of-the-minority vote. Thus, the Court suggested that the timing requirement was met.

The Court proceeded to evaluate the other *M & F Worldwide* elements, finding that the Special Committee and the minority approvals were effective. The Court rejected the plaintiffs' challenge to the independence and efficacy of each of the Special Committee members, finding that none of the factual allegations sufficed to rebut the presumption of their independence or meet the "high standard" to allege a due care claim. Likewise, the Court rejected the plaintiffs' attempts to discredit the efficacy of the minority vote, holding as follows: (1) the vote condition was properly established before Stewart began negotiating the Post-Merger Agreements, (2) the vote was fully informed, and (3) there was no allegation that the inclusion of alleged "insiders" in the vote tally would have defeated majority-of-the-minority approval.

Finally, the Court dismissed the aiding and abetting claim against Sequential because the plaintiffs failed to state an underlying breach of fiduciary duty claim, as required.

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