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MFW Framework Inapplicable Where Conflicts Are Not Adequately Disclosed to Stockholders


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Following other recent decisions addressing the applicability and scope of *Kahn v. M&F Worldwide Corp*. ("*MFW*"), including *In re Match Group Inc., Derivative Litigation* and *Tornetta v. Musk*, on May 1, 2024, the Delaware Supreme Court in *City of Sarasota Firefighters' Pension Fund et al. v. Inovalon Holdings, Inc.* held that Inovalon Holdings, Inc., its CEO and its board of directors failed to comply with *MFW*'s fully informed stockholder vote requirement and therefore could not avail themselves of business judgment rule protection.

As previously described in an earlier Quorum article, in *In re Match Group, Inc.*, the Delaware Supreme Court held that in order to receive business judgment review, a transaction must be subject to both (1) approval by an independent special committee and (2) an uncoerced, fully informed vote by minority stockholders. The Court found that the stockholder vote approving the transaction in the Inovalon case was not fully informed because potential conflicts of interest of the financial advisors were not adequately disclosed to the company's board or to its stockholders in the proxy statement. The decision highlights the importance of disclosure of potential conflicts to qualify for business judgment rule treatment under *MFW*.

Following an acquisition proposal from Nordic Capital, Inovalon's board engaged J.P. Morgan to explore strategic alternatives. Inovalon's founder and CEO, along with a former Inovalon director, collectively held approximately 86% of Inovalon's voting power and the CEO, along with certain other Inovalon stockholders, intended to roll over a portion of their equity. As a result, a special committee of the Inovalon board was formed and Evercore was hired as the special committee's financial advisor. The board and special committee became aware of certain conflicts of interest involving the financial advisors. Both J.P. Morgan and Evercore had provided advisory services to Nordic and members of the buyer investor consortium in the past and Evercore was performing concurrent work for Nordic in an unrelated $20 billion fundraising. The conflicts were disclosed to the board two weeks after the parties had signed a merger agreement and were not described in the proxy statement.

Certain stockholders challenged the transaction, accusing the CEO and the other Inovalon directors of breaching their fiduciary duties, and claiming that Inovalon's proxy statement failed to adequately disclose the conflicts of the two financial advisors. The Court of Chancery had previously dismissed the claims, finding that the *MFW* requirements had been satisfied and that the majority-of-the-minority vote for the transaction was sufficiently informed.

On appeal to the Delaware Supreme Court, the plaintiffs argued that (1) the transaction failed the *MFW*'s "*ab initio*" test because the founder had engaged in significant negotiations prior to the formation of the special committee and (2) the majority-of-the-minority vote was not fully informed due to inadequate disclosure of potential conflicts of interest of the financial advisors. Focusing on the plaintiffs' second argument, the Supreme Court reversed the Court of Chancery, finding that the proxy statement failed to include important details involving J.P. Morgan and Evercore, thus rendering the minority stockholders' vote not fully informed. In its decision, the Court stated, that it was "misleading for the Proxy to state that Evercore 'may' provide advisory services to Nordic and [a member of its investor consortium] when, in fact, it was providing such services, and thus there was an actual concurrent conflict. Evercore's concurrent representation, in unrelated transactions, of Nordic, the bidder of the Company, and the equity consortium member, a co-investor, were material facts." The Court also found that the proxy statement failed to disclose the fact that J.P. Morgan had collected nearly $400 million in fees for prior work it had done for members of the buyer investor consortium.

The decision also reinforced the Delaware Supreme Court's March 24, 2024 decision in *City of Dearborn Police & Fire v. Brookfield Asset Management*, with the Court finding in both cases that information relating to the independence and potential conflicts of a special committee and its advisors "are uniquely important considerations for minority stockholders when deciding how to vote." The Court further explained that whether information is material and thus should be disclosed in the proxy statement should be assessed from the viewpoint of a reasonable stockholder. However, due to "the central role played by investment banks in the evaluation, exploration, selection, and implementation of strategic alternatives…full disclosure of investment banker compensation and potential conflicts" is required. Consequently, the "cleansing" process under the *MFW* framework could not apply, and the Court remanded the matter to be reviewed under the entire fairness standard.

The decision emphasizes the need for special committees to examine any potential conflicts of interest among their financial and legal advisors at the outset of engagement, ensure inquiries are made to identify any such conflicts and, if material conflicts are identified, consider whether continued engagement is appropriate and/or fully disclose such conflicts to minimize their impact.