DELAWARE CORPORATE LAW BULLETIN

Chancery Court Analyzes *MFW's* "*Ab Initio*" Requirement in Controlling Stockholder Litigation

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Distinguishes exploratory "discussions" from "negotiations" in determining that MFW's "ab initio" requirement was satisfied.

INTRODUCTION

The judicial standard of review applicable to controlling stockholder litigation has undergone an interesting evolution over the past thirty-five years. These transactions generally come in one of three forms: (1) a buyout of public stockholders by the controlling stockholder; (2) a third-party buyout in which the controlling stockholder receives preferential, or "disparate," treatment; and (3) a transaction between two corporations with the controlling stockholder on both sides. The foregoing discussion is relevant to all three variations.

A. Evolution of the MFW Playbook

The evolutionary process began with the seminal decision of the Delaware Supreme Court in *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), announcing that the exacting entire fairness standard governs controling stockholder-related litigation. Further, the *Weinberger* Court placed the burden of proving entire fairness on the controlling stockholder. Over ten years later, *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110 (Del. 1994), reaffirmed that entire fairness was the "exclusive standard of judicial review." However, the *Kahn* Court added that if the transaction was approved by *either* "an independent committee of directors *or* an informed majority of minority shareholders," then the burden of proof would be shifted to plaintiff stockholders to prove the transaction was unfair (emphasis added). Thereafter, controlling stockholders generally conditioned their transactions on approval by a special committee of independent directors. Transaction planners were reluctant to employ a majority-of-the-minority stockholder vote due, in large measure, to the leverage such a vote could bestow upon a well-organized and vocal minority.

In response to this concern, the Delaware Court of Chancery ("*Chancery Court*") ruled for the first time in *In re MFW Shareholders Litigation*, 67 A.3d 496 (Del. Ch. 2013) ("*MFW I*"), that a controlling stockholder-led transaction will be reviewed under the deferential business judgment rule when conditioned on approval by *both* a special committee of independent directors and an informed vote of a majority of public stockholders. Then-Chancellor Leo E. Strine, Jr. granted the controlling stockholder's motion for summary judgment, albeit after what he termed "extensive discovery" by plaintiffs lasting eight months. In *MFW I*, then-Chancellor Strine offered the hope that business judgment review would, going forward, be available to controlling stockholders who utilized the dual protective devices to prevail on an early motion to dismiss.

The following year, the Delaware Supreme Court affirmed *MFW I* in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) ("*MFW II*"). The *MFW II* Court promulgated a six-factor test (the "*MFW Playbook*") as a prerequisite for application of business judgment review in controlling stockholder litigation:

> [] [T]he [controlling stockholder] conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; [2] the Special Committee is independent; [3] the Special Committee is empowered to freely select its own advisors and to say no definitively; [4] the Special Committee meets its duty of care in negotiating a fair price; [5] the vote of the minority is informed; and [6] there is no coercion of the minority.

Importantly, the *MFW II* Court stipulated that the first prong of the *MFW Playbook*—the proposed transaction is subject to approval by *both* a special board committee and disinterested stockholders must be announced by the controlling stockholder before any negotiations took place. This has become known as the *ab initio* requirement.

In the course of affirming *MFW I*, however, the *MFW II* Court cast doubt on whether controlling stockholders would be able to obtain dismissal at the pleading stage, even when they adhere to the *MFW Playbook*. In an ominous footnote to its opinion, the *MFW II* Court indicated it would not be possible, pre-trial, to determine whether an independent committee satisfied the fourth factor by negotiating a fair price. In this connection, the Court noted the pretrial record alone was an insufficient basis to examine the "substance" and "efficacy" of a committee. Rather, discovery would be necessary to more fully examine the sufficiency of the process.

B. The Chancery Court Weighs In

Despite this admonition, the Chancery Court has applied business judgment review to grant early dismissal of controlling stockholder litigation where the transaction was structured consistent with the *MFW* Playbook. In *Swomley v. Schlecht*, C.A. No. 9355-VCL, 2015 WL 1186126 (Del. Ch. Mar. 12, 2015), *aff'd*, 128 A.3d 992 (Del. 2015), Vice Chancellor J. Travis Laster found the pre-trial record alone sufficient to establish compliance. Accordingly, the Vice Chancellor applied business judgment review in granting the controlling stockholder's motion to dismiss. (For a discussion of *Swomley*, see Robert S. Reder & Lauren Messonnier Meyers, *Delaware Supreme Court Affirms Pleading-Stage Dismissal of Control Stockholder Buyout Litigation*, 69 VAND. L. REV. EN BANC 17 (2016).)

The next year, Vice Chancellor Laster doubled down in *In re Books-A-Million, Inc. Stockholders Litigation*, C.A. No. 11343-VCL, 2016 WL 5874974 (Del. Ch. Oct. 10, 2016), *aff'd*, 164 A.3d 56 (Del. 2017). The Vice Chancellor noted that when "defendants have described their adherence to the elements identified in [*MFW II*], 'in a public way suitable for judicial notice, such as board resolutions and a proxy statement,' then the court will apply the business judgment rule at the motion to dismiss stage." (For a discussion of *In re Books-A-Million*, see Robert S. Reder, *Delaware Court Grants Pleading-Stage Dismissal of Litigation Challenging Control Stockholder-Led Buyout*, 70 VAND. L. REV. EN BANC 217 (2017).)

While awaiting word from the Delaware Supreme Court on the appropriateness of pleading-stage dismissal under *MFW II*, the Chancery Court has moved to clarify various aspects of the *MFW Playbook*. Earlier this year, in *In re Synutra International, Inc. Stockholder Litigation*, No. 2017-0032-JTL, 2018 WL 705702 (Del. Ch. Feb. 2, 2018), Vice Chancellor Laster clarified the operation of *MFW II's ab initio* requirement. The controlling stockholder had initially submitted a "preliminary non-binding proposal" that was silent as to board and stockholder approvals. Two weeks later, after the target board formed a special committee but before any negotiations took place, the controlling stockholder sent a revised proposal explicitly conditioned on application of the dual approval requirements of the first prong of the *MFW Playbook*. The Vice Chancellor found this timing satisfied the *ab initio* requirement. Specifically, he found the promptness of the revised proposal prevented the controlling stockholder "from using the [*MFW*] conditions as bargaining chips." Applying business judgment review, the Vice Chancellor granted defendants' motion to dismiss. (For a discussion of *In re Synutra*, see Robert S. Reder, *Chancery Court Again Grants Early Dismissal of Litigation Challenging Control Stockholder-Led Buyout*, 72 VAND. L. REV. EN BANC 11 (2018).)

Four months later, in *Olenik v. Lodzinski*, C.A. No. 2017-0414-JRS, 2018 WL 3493092 (Del. Ch. July 20, 2018), Vice Chancellor Joseph R. Slights III recognized, for purposes of *MFW*'s *ab initio* requirement, an "important distinction" between exploratory "discussions" and "negotiations." The Vice Chancellor held that a formal proposal, which expressly conditioned the transaction on the dual committee and stockholder approvals, satisfied the *ab initio* requirement despite ten months of "extensive" preliminary discussions *preceding* the formal offer. In granting the controlling stockholder's motion to dismiss, the Vice Chancellor was reassured by the two months of substantial negotiations that took place *after* submission of the formal offer.

I. FACTUAL BACKGROUND

Earthstone Energy, Inc. ("*Earthstone*"), an independent "upstream" oil and gas company with assets in Texas and North Dakota, acquired Bold Energy III LLC ("*Bold*") through an all-stock business combination resulting in the companies' respective stockholders owning 39% and 61% of the combined entity. This was a natural combination, as Earthstone "was a mature company with increasing revenue . . . but with limited undeveloped resources," while Bold was "an early-stage oil and gas company" that, "[a]s compared to Earthstone . . . generated far less revenues but owned approximately three-times more undeveloped resources" in Texas and New Mexico.

Before the combination, Oak Valley Resources, LLC ("*Oak Valley*"), a "holding company for . . . investment opportunities in upstream oil and gas companies" founded by Frank Lodzinski, was Earthstone's largest stockholder, owning 41.1% of its outstanding shares. EnCap Investments, L.P. ("*EnCap*"), a "private equity firm," in turn owned 57.3% of Oak Valley, as well as 95.9% of Bold. Of Earthstone's nine-member board of directors (the "*Board*"), seven were appointed by Oak Valley and two were considered independent (although each owned interests in Oak Valley). Lodzinski, who served as Earthstone's chairman and chief executive officer, also held a non-controlling interest in Oak Valley.

Beginning in November 2015, as part of Earthstone's search for potential acquisition targets, Lodzinski reached out to EnCap to discuss its portfolio companies, including Bold. Substantial discussions among Earthstone management, EnCap, and Bold concerning a potential Earthstone-Bold combination continued over the next nine months. In July 2015, the Board formed a special committee composed of its two independent directors (the "*Special Committee*") to evaluate whether to make a formal offer to Bold. The Special Committee's mandate included the right to "[r]eject the potential transaction, cease further negotiations and 'walk-away.' " The Board agreed not to "approve a transaction with Bold without a favorable recommendation from the Special Committee."

A month later, Earthstone submitted a formal proposal (the "*Offer Letter*") to Bold that explicitly conditioned the proposed transaction on approval by both the Special Committee and a majority of Earthstone's public stockholders. After two months of negotiations over the proposed equity split, which included numerous offers and counteroffers, a definitive combination agreement was approved by the Special Committee, the Board, and the owners of 99.7% of the non-affiliated shares voting on the transaction. Lodzinski served as the

Special Committee's lead negotiator in connection with these negotiations. The combination was well-received by the market, as "Earthstone's stock price rose 27% on the day of the announcement" and continued to rise during the period leading up to the stockholders' meeting.

Nicholas Olenik, an Earthstone stockholder, challenged the transaction by filing a breach of fiduciary duty claim in Chancery Court, alleging the Board approved an unfair transaction favoring the interests of Oak Valley and EnCap over those of the public stockholders. Olenik asserted that entire fairness, rather than business judgment, was the applicable standard of review because EnCap and Oak Valley, as controlling stockholders of Earthstone and Bold, failed to satisfy the elements of the *MFW Playbook*. Specifically, Olenik alleged that (i) negotiations took place before announcement of the *ab initio* conditions, (ii) the Special Committee lacked independence and failed to satisfy its duty of care in negotiating the deal, and (iii) the public stockholder vote was uninformed. In response, the defendants filed a motion to dismiss.

II. VICE CHANCELLOR SLIGHTS'S ANALYSIS

At the outset of his analysis, Vice Chancellor Slights observed that "[t]he battle lines drawn by the parties mark familiar territory" in terms of fixing the applicable standard of review. The Vice Chancellor found it unnecessary to decide whether EnCap and Oak Valley actually controlled Earthstone because he determined the parties had in fact abided by the *MFW Playbook*. On this basis, the Vice Chancellor applied the deferential business judgment rule and granted defendants' motion to dismiss.

*A. Satisfaction of the "*Ab Initio*" Requirement*

The critical issue for Vice Chancellor Slights, in analyzing satisfaction of the *ab initio* requirement, was determining when "negotiations" began. The Vice Chancellor noted that, "[i]n order truly to mimic arms-length dealing, and to neutralize the controller's influence, these two conditions must be in place '*ab initio*,' meaning the conditions must be announced 'before any negotiations [take] place.' " "[I]n most instances, 'negotiations' begin when a proposal is made by one party which, if accepted by the counter-party, would constitute an agreement between the parties regarding the contemplated transaction." The point of the *ab initio* requirement is to ensure the controller "cannot dangle a majority-of-the-minority vote before the special committee late in the process as a deal-closer rather than having to make a price move."

Claiming the *ab initio* requirement had not been satisfied, Olenik pointed to the ten months of "substantial preliminary discussions" between Lodzinski, EnCap, and Bold preceding the Offer Letter. During these ten months, the parties engaged in a flurry of activities, including: (i) telephone conferences discussing the parameters of a potential Earthstone-Bold combination; (ii) data room access to review Bold's assets and "technical, operational, financial and analytical information"; (iii) an update letter from Lodzinski to the Board indicating an "inten[t] to make [an] offer" to Bold; (iv) an initial "non-binding presentation" from Earthstone to EnCap based on a $305 million equity valuation and an updated presentation based on a $335 million valuation reflecting Bold's recently acquired assets; and (v) a meeting between Earthstone management, EnCap, and EnCap's counsel "to develop a preliminary timeline . . . and assign responsibilities to complete the proposed transaction." Only after these activities took place did the Board form the Special Committee.

Rejecting Olenik's argument, Vice Chancellor Slights recognized an " important distinction between 'discussions' about the possibility of a deal and 'negotiations' of a proposed transaction after the 'discussions' lead to a definitive proposal." This distinction was addressed by the Delaware Supreme Court in *Colonial School Board v. Colonial Affiliate, NCCEA/DSEA/NEA*, 449 A.2d 243, 247 (Del. 1982):

> No dictionary references are needed to know that to "negotiate" means to bargain toward a desired contractual end, whereas to "discuss" means merely to exchange thoughts and points of views on matters of mutual interest, with no bargaining overtones necessarily involved.

Vice Chancellor Slights viewed the preliminary discussions preceding the Offer Letter, although "extensive," as merely "exploratory in nature." These discussions "never rose to the level of bargaining." By contrast, the Offer Letter was followed by two months of substantial negotiations "that included several attacks, parries and remises before a final deal was struck." More particularly, while the Offer Letter proposed that Earthstone stockholders would own 45% of the combined entity, after a series of counteroffers, the parties reached definitive agreement on an equity split of 39% for Earthstone stockholders and 61% for Bold stockholders (principally EnCap).

Given this record, Vice Chancellor Slights viewed the Offer Letter as "the first real move in the negotiating bout." And because the Offer Letter expressly conditioned the transaction on " 'final approval by Earthstone's Special Committee' and 'formal approval of Earthstone's stockholders . . . other than EnCap,' " the Vice Chancellor reasoned that "[b]y conditioning the first offer in this manner, the Special Committee made clear to Bold and EnCap that the 'procession of the transaction' would be subject to these terms. That is precisely what *MFW* requires."

B. The Other MFW Playbook *Requirements*

Regarding the second prong of the *MFW Playbook*, Olenik alleged the Special Committee members lacked independence because (i) they were appointed to the Board by Oak Valley, which was controlled by EnCap; (ii) they had financial interests in Oak Valley; and (iii) one of the committee members previously invested in companies led by Lodzinski. The Vice Chancellor found these facts, whether standing alone or cumulatively, insufficient to compromise the Special Committee's independence.

The third prong of the *MFW Playbook* requires the special committee to have both the authority to hire independent legal and financial advisors and the power to "say no definitively." The Vice Chancellor was satisfied that each of these elements had been satisfied because the Board resolution forming the Special Committee explicitly authorized both.

Regarding the fourth prong of the *MFW Playbook*, Olenik claimed the Special Committee violated its duty of care by delegating negotiations to Lodzinski, an allegedly conflicted officer, and rubber-stamping deal terms favoring the controlling stockholders and Lodzinski. The Vice Chancellor, concluding these allegations failed to satisfy the gross negligence pleading standard, held that the record demonstrated due care on the part of the Special Committee. In this regard, the Vice Chancellor emphasized the sixteen meetings held by the Special Committee, its active consultations with its advisors, and the extensive negotiations over the equity split *after* submission of the Offer Letter. On the other hand, the Vice Chancellor found it unremarkable that Lodzinski, given his extensive industry experience and expertise, facilitated exploratory discussions with EnCap and served as the Special Committee's lead negotiator.

Addressing the last prong of the *MFW Playbook*, Vice Chancellor Slights found that the Board had disclosed all material information to stockholders and, specifically, was under no obligation to characterize its financial advisor's analysis "in a particular manner, or to disclose all iterations" of its advisor's work. Further, regarding Lodzinski's role in the process, the Vice Chancellor concluded it was "not surprising and certainly not a material fact" that the Special Committee authorized an officer with "forty-three years of experience in the oil and gas industry" to talk directly with the financial advisor. In addition, the Special Committee actively oversaw the valuation process and engaged directly with its advisors and management during the negotiations.

CONCLUSION

It could be argued that Vice Chancellor Slights's distinction between "discussions" and "negotiations" provides limited guidance to transaction planners. In the three months leading up to delivery of the Offer Letter, Earthstone provided two nonbinding proposals to EnCap containing specific valuations for the proposed combination. Such proposals would seem to display the very "bargaining overtones" that the Vice Chancellor viewed as a distinguishing factor of negotiations, as opposed to preliminary discussions. Nevertheless, neither *Olenik* nor *In re Synutra* were non-binding proposals found to start the *ab initio* clock. This is not particularly surprising, inasmuch as controlling stockholders and their representatives are accustomed to testing the waters, gathering relevant information, and gauging interest before laying their cards on the table. Experienced legal counsel might not even be consulted until the exploratory process has progressed to this point.

Nevertheless, transaction planners are well-advised to communicate the *MFW Playbook*'s *ab initio* conditions sooner rather than later in connection with a controlling stockholder-related transaction. One cannot be certain, *ex ante*, where a court may draw the elusive line between discussions and negotiations. On the other hand, *Olenik* and *In re Synutra* do provide corporate litigators with helpful *ex post* counterarguments when plaintiffs challenge whether the *ab initio* conditions have been timely communicated.