// DELAWARE CORPORATE LAW BULLETIN

Negotiating Against Yourself: Flawed Negotiating Process Leads Chancery Court to Deny *M&F*-Premised Motion to Dismiss

*Robert S. Reder**

*Matthew K. Vallade***

**Professor of the Practice of Law at Vanderbilt University Law School. Professor Reder has been serving as a consulting attorney at Milbank LLP in New York City since his retirement as a partner in April 2011.*

***Vanderbilt University Law School, J.D. Candidate, May 2020.*

Also refuses pleading stage dismissal of claims brought against controlling stockholder and target company directors for breach of stockholder agreement and DGCL § 203

INTRODUCTION 214
I. FACTUAL BACKGROUND 216
A. *Delek's Initial Purchase of Alon Stock* 216
B. *Negotiations During Standstill Period* 217
C. *Negotiations After Standstill Period* 218
D. *Litigation Ensues* 219
II. VICE CHANCELLOR MCCORMICK'S ANALYSIS 220
A. *Breach of Stockholder Agreement* 220
1. Standing 220
2. Breach and Damages 220
B. *Breach of DGCL § 203* 221
C. *Breach of Fiduciary Duty by Delek and Director Defendants* 221

1. Controlling Stockholder 222
2. M&F.. 222
3. Entire Fairness 223
4. Delek Directors 224
5. Special Committee Members 224
D. Disclosure Claims 224
CONCLUSION 225

INTRODUCTION

In recent years, the Delaware Court of Chancery ("*Chancery Court*") has considered numerous stockholder challenges to corporate transactions benefitting a controlling stockholder. Traditionally, due to the obvious conflicts posed by these transactions, the Chancery Court applied the heightened entire fairness standard of review rather than the deferential business judgment rule and, accordingly, rarely granted defendants' motions to dismiss. All that changed in 2014.

In *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) ("*M&F*"), the Delaware Supreme Court forged a path for controlling stockholder-led transactions to regain the benefit of deferential business judgment review. The *M&F* court promulgated a six-part framework ("*M&F Framework*") whereby controlling stockholders and company directors can secure business judgment review:

> (i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.

A footnote in *M&F* created doubt whether, going forward, adherence to the *M&F* Framework would permit dismissal at the pleading stage. However, the Chancery Court subsequently has granted motions to dismiss on the basis of satisfaction of the *M&F* Framework on several occasions. For an analysis of some of these decisions, *see* Robert S. Reder & Elizabeth F. Shore, *Chancery Court Applies M&F Framework to Transactions in Which Controlling Stockholders Allegedly Received "Unique Benefits*," 72 VAND. L. REV. EN BANC 221 (2019) ("*Reder & Shore*").

The typical transaction in which Delaware courts apply entire fairness is a controlling stockholder-led corporate buyout. This has not constrained the Chancery Court, however, from extending application of the *M&F* Framework to other types of corporate transactions where

controlling stockholders are alleged to have received a unique benefit relative to public stockholders. For an analysis of some of these decisions, *see Reder & Shore*. More recently, in *Tornetta v. Musk*, C.A. No. 2018-0408-JRS, 2019 WL 4566943 (Del. Ch. Sept. 20, 2019), although the Chancery Court denied pleading stage dismissal because Tesla failed to follow the *M&F* Framework when awarding a lucrative compensation package to CEO Elon Musk, it nevertheless opined that, had the *M&F* Framework been satisfied, "the Court's suspicions regarding the controller's influence would have been assuaged and deference to the Board and stockholder decisions would have been justified."

In *M&F*, the first prong of the *M&F* Framework—approval of the proposed transaction by *both* a special board committee *and* disinterested stockholders ("*Dual Protections*")—was announced by the controlling stockholder before any negotiations took place. The exact parameters of this so-called ab initio requirement were tested in several subsequent Chancery Court proceedings. Finally, in *Olenik v. Lodzinski*, 208 A.3d 704 (Del. 2019) ("*Olenik*"), the Delaware Supreme Court reversed a pleading stage dismissal because the Dual Protections "were not put in place early and before substantive economic negotiations took place." Rather, "the well-pled facts in the complaint support a pleading stage inference that the preliminary discussions transitioned to substantive economic negotiations when the parties engaged in a joint exercise to value [the two companies]" *before* delivery of a formal offer letter. As such, "these valuations set the field of play for the economic negotiations to come by fixing the range in which offers and counteroffers might be made." For an analysis of *Olenik* and related decisions, *see* Robert S. Reder, *Delaware Supreme Court Explores Application of MFW's "Ab Initio" Requirement in Controlling Stockholder-Related Litigation*, 72 VAND. L. REV. EN BANC 237 (2019).

Not long after the *Olenik* court added color to *M&F*'s ab initio requirement by adopting the "substantive economic negotiation" analysis, the Chancery Court faced this and other issues in *Arkansas Teacher Ret. Sys. v. Alon USA Energy, Inc.,* C.A. No. 2017-0453-KSJM, 2019 WL 2714331 (Del. Ch. June 28, 2019) ("*Alon USA*"). In *Alon USA*, a target company minority stockholder challenged a transaction where a stockholder owning "48% [of the] equity interest" in the target purchased the remainder of the outstanding stock via a merger transaction. In sorting out this dispute, Vice Chancellor Kathaleen S. McCormick probed several thorny issues, including (i) whether plaintiff had standing as a third-party beneficiary to enforce a stockholder agreement to which it was not a party; (ii) if so, whether the

negotiations leading up to the merger violated the stockholder agreement; (iii) related questions under seldom-litigated Section 203 of the Delaware General Corporation Law ("*DGCL § 203*"); (iv) whether the acquirer exercised "*de facto* control" of target so as to invoke the entire fairness standard of review; and (v) if so, whether the parties satisfied the *M&F* Framework and, in particular, the ab initio requirement to regain benefit of business judgment review.

I. FACTUAL BACKGROUND

A. Delek's Initial Purchase of Alon Stock

In 2015, Delek US Holdings, Inc. ("*Delek*"), "a diversified downstream energy company," began negotiations for the purchase of 48% of the common stock of Alon USA Energy, Inc. ("*Alon*"), "an independent retailer and marketer of petroleum products," from Alon's then-largest stockholder, Alon Israel Oil Company, Ltd. ("*Alon Israel*"). Because Delek wanted to avoid the restrictions imposed by DGCL § 203, Delek requested the Alon board of directors ("*Board*") to preapprove the transaction before completing the purchase. Absent prior Board approval, DGCL § 203 "prohibits a stockholder from engaging in a business combination with a company within three years from the date it acquires 15% or more of the company's outstanding voting equity." A special committee formed by the Board approved Delek's stock acquisition, "but conditioned that approval on Delek executing a stockholder agreement."

On May 14, 2015, Delek completed the stock purchase from Alon Israel for $16.99 per share ("*Initial Stock Purchase*"). Shortly thereafter, five of Alon's eleven directors resigned from the Board, paving the way for Delek to appoint "five Delek executives to fill the positions . . . ." One of these Delek executives, President and CEO Ezra Uzi Yemin ("*Yemin*"), became Executive Chairman of the Board, replacing the prior chairman, David Wiessman ("*Wiessman*"). Wiessman continued as a member of the Board.

Five days after closing the Initial Stock Purchase, Delek entered into the stockholder agreement mandated by the special Board committee ("*Stockholder Agreement*" or "*Agreement*"). The Stockholder Agreement prohibited Delek "from acquiring more than 49.99% of Alon's outstanding equity or entering into any material contract with Alon unless Delek first obtained approval from an 'Independent Director Committee.' " This restriction was scheduled to expire on the first anniversary of the Initial Stock Purchase ("*Standstill Period*"),

versus the three-year standstill mandated by DGCL § 203. The Independent Director Committee was to be "comprised solely of two or more Independent Directors," specifically "exclud[ing] any directors affiliated with . . . Delek."

B. Negotiations During Standstill Period

Despite the Stockholder Agreement restrictions, in August 2015, Yemin articulated Delek's intention to purchase the remaining Alon stock when, on a public earnings call, he stated "[o]bviously . . . we are not in the business of holding 48% in a company." On October 8, Wiessman asked Yemin "whether there was a transaction that Delek would contemplate in the near term . . . ." Yemin responded that any transaction between Delek and Alon would need to be structured as a stock-for-stock exchange, adding later that "any deal . . . would need to be at an exchange ratio reflecting a discount to current Alon market price."

On October 30, "the Board formally approved the formation of the Special Committee" excluding the five Delek designees ("*Special Committee*") and, although the Board "authorized the Special Committee to engage advisors," it "did not fully delineate the committee's powers until October 2016—a year later." In the interim, it was unclear whether the Special Committee "had the authority to explore alternative transactions or reject a deal with Delek." The Special Committee did engage J.P. Morgan Securities LLC ("*J.P. Morgan*") as its financial advisor.

In January 2016, Delek "released an investor presentation that included information on Delek's plans to either acquire the remaining 52% or acquire an additional 3% of Alon stock." On January 29, Delek negotiated an amendment of the Stockholder Agreement replacing two non-Delek designees with two new directors named by Delek.

Then, in February, Yemin "shifted gears," alerting Wiessman, now acting as Chairman of the Special Committee, that Delek was "exploring paying 80% of the merger consideration in cash." Wiessman "responded that the Special Committee would expect a premium on the cash consideration." Not willing to wait for Delek, the Special Committee "decided to prepare a proposal letter for Delek suggesting a stock-for-stock merger" with an exchange ratio based "on then-current market prices instead of any premium deal."

A month later, Yemin "revised its message again," indicating "Delek was exploring paying 50% of the merger consideration in cash, and that Delek understood . . . such a structure would require a

premium." Wiessman rejected this approach as "it would trigger 'make whole' payments under Alon's debt covenants and be a taxable event for Alon's stockholders."

In April, the Special Committee proposed to Delek a "stock-for-stock deal with an at-the-market exchange ratio of 0.687 shares . . . ." No doubt anticipating an *M&F* defense, this proposal "raised *for the first time* that any deal should be conditioned on Special Committee approval and a majority-of-the-minority vote" (emphasis added). Yemin rejected this proposal.

On a May 6 earnings call, Yemin revealed the discussions with Alon but noted "'it doesn't make sense' for there to be a transaction at an exchange ratio based on current market prices." The following day, "Alon's stock price fell by 7%, thereby pushing any exchange ratio in Delek's favor." The Special Committee desired to publicly respond, but Delek "demanded" it refrain from doing so.

C. Negotiations After Standstill Period

The Standstill Period expired on May 15 and, just three days later, Delek sent the Special Committee a letter stating it "would be in contact when market conditions improved." Again not willing to wait, ten days later the Special Committee "sent a new written proposal to Delek lowering the proposed stock-for-stock exchange ratio to 0.615 in Delek's favor." When Delek "had yet to provide a substantive response to either one of the Special Committee's two written proposals" by May 15, the Special Committee explored issuing a press release "announcing that it was authorized to explore strategic alternatives." Delek again "sought to restrict Alon's public statements" and forced revisions to the press release.

The Special Committee submitted a third written proposal on October 13, effectively "bidding against itself again by lowering the proposed exchange ratio to a range of 0.527 to 0.563." Delek responded the following day with "an all-stock transaction with a fixed exchange ratio of 0.44 Delek shares for each Alon share, then-equating to $7.62 per Alon share . . . ." Delek's proposal referenced the *M&F* Framework by requiring approval "'by a special committee . . . comprised entirely of directors that are independent of Delek' and the holders of a majority of the non-Delek-affiliated Alon stock."

On October 27, "the Board adopted resolutions that permitted the Special Committee 'to decline any proposal from Delek and to review and evaluate strategic alternatives . . . .' " By this time, Yemin already had "communicated at least twenty-six times with Wiessman

or the Special Committee, and the parties had largely agreed upon deal structure."

In December, "J.P. Morgan provided a financial analysis showing that Delek's . . . offer understated Alon's intrinsic value." Toward the end of the month, under J.P. Morgan's guidance, Wiessman proposed an enhanced exchange ratio of 0.504. The following day, "Yemin provided Wiessman with Delek's 'best and final' offer reflecting the 0.504 exchange ratio."

On January 2, 2017, J.P. Morgan provided the Special Committee with a fairness opinion for a transaction based on Delek's proposed exchange ratio. Although this ratio implied a $12.13 per share merger price, representing "a 6.6% premium to Alon's closing price on the same day," certain analyses underlying J.P. Morgan's opinion "did not support the merger consideration." For instance, J.P. Morgan's "sum-of-the-parts analysis yielded a per share price range of $15.60 to $18.90," while its "two discounted cash flow analyses yielded price ranges above the merger price." In its evaluation of the offer, "the Special Committee relied in part on a 'relative valuation' methodology, which focused on the trading prices of Alon's stock and Delek's stock as opposed to the intrinsic value of Alon." However, this methodology "did not account for potential manipulation of the companies' stock trading prices." To further complicate matters, but "unbeknownst to the Special Committee," between August and November "J.P. Morgan and its affiliates had increased their holdings in Delek by almost 60%."

With the fairness opinion in hand, the Special Committee unanimously approved the transaction and recommended adoption to the Board. Shortly thereafter, the Board "adopted resolutions approving the deal and recommending that Alon's stockholders vote in favor . . . ." At an Alon stockholders meeting approving the transaction, "stockholders unaffiliated with Delek own[ing] 79% of the outstanding shares voted in favor of the merger." After the transaction closed on July 1, Wiessman and another Alon director secured directorships with Delek-controlled entities.

D. Litigation Ensues

The Arkansas Teacher Retirement System ("*Plaintiff*") challenged the transaction with a suit in Chancery Court against Delek and the Board members (collectively, "*Defendants*"). Plaintiff's claims included (A) breach of the Stockholder Agreement by Defendants, which in turn "vitiated the Board's waiver" of DGCL § 203, and (B) breach of fiduciary duty on the part of Defendants by (i) "consummating the

merger," (ii) "violating and failing to enforce the . . . Stockholder Agreement and Section 203," and (iii) "making materially false and incomplete disclosures" in the proxy materials distributed by the Board to solicit Alon stockholder approval of the transaction ("*Proxy*"). Defendants moved to dismiss all counts.

II. VICE CHANCELLOR MCCORMICK'S ANALYSIS

Vice Chancellor McCormick evaluated whether any of Plaintiff's claims withstood Defendants' motion to dismiss. With the narrow exception of one of several disclosure claims, none did.

A. Breach of Stockholder Agreement

1. Standing

Because "only parties to a contract and intended third-party beneficiaries have standing to sue for breach of the contract," the Vice Chancellor first considered whether Plaintiff was a third-party beneficiary of the Stockholder Agreement. To qualify as a third-party beneficiary,

> (i) the contracting parties must have intended that the third[-]party beneficiary benefit from the contract, (ii) the benefit must have been intended as a gift or in satisfaction of a pre-existing obligation to that person, and (iii) the intent to benefit the third party must be a material part of the parties' purpose in entering into the contract.

The Vice Chancellor found Plaintiff satisfied the *first element* since "it received a direct as opposed to an incidental benefit from the Agreement." Because "the terms of the Agreement mimic Section 203's anti-takeover protections by preventing Delek from entering into transactions with Alon" and "Section 203 protections directly benefit stockholders," then "[i]t follows that the Agreement provides direct benefits to stockholders." Next, the *second element* was met because "it is reasonable to infer that the benefits conferred by the Agreement were intended to satisfy pre-existing legal obligations—those provided by Section 203—and are otherwise a gift." Finally, Plaintiff satisfied the *third element* because "the anti-takeover protections in the Agreement are a material part of its purpose." Therefore, as a "third-party beneficiary," Plaintiff "has standing to sue for breach of the Agreement."

2. Breach and Damages

The Vice Chancellor concluded Plaintiff "allege[d] facts sufficient to support a claim for breach of the Standstill Provision."

Various actions taken by Delek "prior to the expiration of the Standstill Period," including "[p]ublicly announc[ing] its intent to acquire Alon," exchanging "non-public information," "negotiat[ing] substantive terms of the merger prior," and "[s]uggest[ing] . . . a stock-for-stock merger structure and 'an exchange ratio reflecting a discount to current Alon market price,' " informed the Vice Chancellor's finding that it was "reasonably conceivable that Delek was seeking to acquire Alon during the Standstill Period" in violation of the Stockholder Agreement. Finally, the Vice Chancellor found Plaintiff adequately alleged damages from the breach by contending (i) Delek consummated the merger "on terms far less favorable to Alon stockholders than if the terms of the [Agreement] had been honored" and (ii) "Delek's alleged breaches, including its public statements, depressed Alon's stock price, thereby manufacturing more favorable market conditions" relative to Delek's offer.

B. Breach of DGCL § 203

Not only had Delek and Alon violated the Stockholder Agreement "by entering into the merger" but, Plaintiff claimed, "because Section 203 prohibited the merger, the merger was void ab initio . . . ." Plaintiff based this contention on the "creative argument" that the parties' breach of the Stockholder Agreement "vitiated Alon's Section 203 approval, and thereby restored Section 203's protections." While these "logical leaps" may not "ultimately land" at a trial, the Vice Chancellor found them sufficient to avoid a pleading stage dismissal. To rebut Defendants' argument that Alon stockholders had approved the merger for purposes of DGCL § 203, the Vice Chancellor responded that Plaintiff "has adequately alleged that the stockholder vote was not fully informed . . . ."

C. Breach of Fiduciary Duty by Delek and Director Defendants

In response to Plaintiff's claim that "Delek breached its fiduciary duties as a controlling stockholder and the individual defendants breached their fiduciary duties as directors," Defendants argued (i) that Plaintiff failed to allege adequately that "Delek was a controlling stockholder"; (ii) even if it was, the transaction followed the *M&F*

Framework; and (iii) even if it did not, Plaintiff failed to adequately allege the transaction was not entirely fair.

1. Controlling Stockholder

Although Delek did not own a majority of Alon's stock, "a minority stockholder can also be deemed a controller" if "(a) the stockholder 'actually dominated and controlled the majority of the board generally'; or (b) the stockholder 'actually dominated and controlled the corporation, its board or the deciding committee with respect to the challenged transaction.' " In other words, the minority stockholder exercised "*de facto* control."

Because "Delek owned approximately 48% of Alon's outstanding stock" and "[f]ive of Alon's eleven directors . . . were directly affiliated with Delek," it was still "reasonably conceivable that Delek exercised actual control over Alon." Moreover, the Vice Chancellor noted that the "allegations concerning Wiessman . . . are sufficient to cast doubt on Wiessman's independence from Delek at the pleadings stage." In support of her findings relating to Delek's de facto control, the Vice Chancellor observed Plaintiff's allegations that Delek "exercised its influence to remove and replace two directors . . . to work the same change upon the composition of the Special Committee; dictated the timing, structure, and price of the merger; and effectively muzzled the Special Committee's public statements to serve Delek's interests." Therefore, "it is reasonably conceivable that Delek is a controlling stockholder, and the entire fairness standard of review therefore presumptively applies to the approval of the merger"—that is, unless *M&F* was available to shift the standard of review.

2. M&F

According to Vice Chancellor McCormick, consistent with the ab initio requirement, the *M&F* Framework must be invoked "at the outset of the process." However, the facts suggested "Delek engaged in substantive economic negotiations before Delek imposed the [*M&F*] conditions." Before either party sought implementation of the *M&F* Framework, Yemin and Wiessman met "six times to discuss potential deal terms." These discussions "were substantive in nature" and "concerned the deal structure, exchange ratio, and price terms." Also, during this period the Special Committee hired J.P. Morgan as its financial advisor and "entered into a confidentiality agreement to permit the exchange of non-public information." As such, "it is reasonably conceivable that the [*M&F*] conditions were not imposed at

the 'germination stage,' but rather, many months after." "Applying the guidance of . . . *Olenik*," the Vice Chancellor concluded, "Plaintiff has pled facts supporting a reasonable inference[ ] that Delek engaged in substantive economic negotiations before Delek imposed the [*M&F*] conditions," depriving Defendants of "business judgment review at the pleadings stage . . . ."

3. Entire Fairness

The applicability of the entire fairness standard is important:

> The possibility that the entire fairness standard of review may apply tends to preclude the Court from granting a motion to dismiss . . . unless the alleged controlling stockholder is able to show, conclusively, that the challenged transaction was entirely fair based solely on the allegations of the complaint and the documents integral to it.

Entire fairness review has two prongs: "fair dealing and fair price." Vice Chancellor McCormick concluded "it is reasonably conceivable that Delek and the Director Defendants did not engage in a fair process or negotiate a fair price . . . ."

With respect to *process*, Plaintiff's complaint "pleads facts supporting a reasonable inference that the process leading to the merger was unfair." For instance, (i) Delek negotiated "significant aspects of the merger" during the Standstill Period "when Delek was contractually precluded from making an offer," (ii) "[t]he Special Committee process was suboptimal," (iii) "the committee's authority was unclear" during the first year of negotiations, (iv) "two directors were removed from the Alon Board early in the process and replaced with individuals selected by Delek," (v) Weissman was allowed to serve as lead negotiator for the Special Committee even though his "independence and disinterest were questionable," and (vi) allegations suggest "the Special Committee failed to inform itself adequately."

With respect to *price*, Plaintiff offered "facts supporting a reasonable inference that the merger consideration was unfair." Because the stock-for-stock structure tied the purchase price "to the companies' respective stock values[,] . . . any decline in Delek's stock price affected the merger price negatively . . . ." To make matters worse, during negotiations, "Delek made multiple public statements that had the effect of pushing down the merger price." Also, not only was the merger price at the "low end of the value ranges" of J.P. Morgan's financial analyses, but also J.P. Morgan's analyses allegedly "improperly excluded management's best estimates of . . . planned growth projects" and used assumptions which "undervalued Alon's common stock."

4. Delek Directors

Delek's Board designees argued the fiduciary duty claims against them must be "dismissed because they recused themselves . . . ." Because "merely recusing oneself from the ultimate decision does not absolve a director of his or her fiduciary duties," the Vice Chancellor saw enough facts to support a pleading stage inference that these directors "participated in the process leading to and the approval of the merger."

5. Special Committee Members

These directors claimed Plaintiff "failed to allege a non-exculpated claim against them." While the Vice Chancellor conceded that they "make a good point" because the "allegations against the committee members . . . are not extensive," based on alleged "deficiencies in the Special Committee's process and issues concerning the merger price," together with alleged "disclosure violations," the Vice Chancellor found it "reasonably conceivable that the Special Committee Defendants acted in bad faith."

D. Disclosure Claims

Vice Chancellor McCormick analyzed "seven categories of allegedly deficient disclosures" in the Proxy, the following six of which "hit the mark":

- Failure to disclose the extent to which the Stockholder Agreement restricted Delek's actions, such as "'seeking to' acquire Alon common stock."
- Failure to disclose J.P. Morgan "increased its stake in the acquirer significantly while advising in negotiations against the acquirer."
- Disclosures regarding the formation of the Special Committee "create an ambiguous and potentially misleading narrative."
- Failure to disclose two new directors were appointed because "Delek demanded the change."
- Failure to disclose "post-merger Board service" for Wiessman and another Director or "that Wiessman would continue as Executive Chairman of Alon Partners G.P."
- Failure to disclose Delek's "plan to acquire the remaining 18.4% of the Partnership's publicly held limited partner interests."

CONCLUSION

In *Alon USA*, Defendants' many missteps led to Vice Chancellor McCormick's refusal to grant their motion to dismiss. Not only did Defendants breach the Stockholder Agreement and cavalierly address the requirements of DGCL § 203, but they also failed to implement the *M&F* Framework in time to gain advantageous business judgment review. Given the significant concerns identified by Plaintiff in the process and pricing for the transaction and the absence of a settlement, the disputes will be played out in a trial on the merits—surely not a spot in which Defendants hoped to find themselves.