DELAWARE CORPORATE LAW BULLETIN

Despite Lack of Control Stockholder, Chancery Court Applies *M&F's* "Ab Initio" Requirement in Determining Whether Independent Committee Recommendation Cleansed Transaction Approved by Conflicted Board

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Substantive economic negotiations preceding formation of special committee and inadequate disclosures to target stockholders prevented pleading-stage dismissal under either Trados II or Corwin

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INTRODUCTION

Traditionally, Delaware courts applied the entire fairness standard of review in assessing the propriety of controlling stockholder-led buyouts. This standard places a heavy burden on the controlling stockholder and target board of directors to establish that the buyout is procedurally fair and offers a fair price. When "entire fairness is the standard of review, a motion to dismiss is rarely granted." *See Salladay v. Lev*, No. 2019-0048-SG, 2020 WL 954032 (Del. Ch. Feb. 27, 2020) ("*Salladay*").

A. M&F Framework

All this changed with the Delaware Supreme Court's decision in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) ("*M&F*"). As written in *Salladay,* the *M&F* Court established a six-part framework (commonly referred to as the "*M&F Framework*") for the target board to "recover business judgment review by making the transaction contingent from inception upon the presence of a fully constituted, fully authorized special committee" of the target board "*and* a vote of informed and un-coerced minority stockholders" ("*Dual Protections*"). When the requirements of the *M&F Framework* are satisfied, pleading-stage dismissal of stockholder challenges to the controlling stockholder-led buyout generally will follow.

One aspect of the *M&F Framework* garnering much attention of late is the so-called "*ab initio*" requirement that the Dual Protections be in place "*up-front*" so "the controlling stockholder knows that it cannot bypass the special committee's ability to say no" during negotiations. Subsequent decisions of the Delaware Supreme Court in *Flood v Synutra Int'l, Inc.*, 195 A.3d 754 (Del. 2018) ("*Flood*") and *Olenik v. Lodzinski*, 208 A.3d 704 (Del. 2019) ("*Olenik*") sought to clarify the ab initio requirement. According to *Flood*, "from the beginning" means "before any substantive economic negotiations begin." *Olenik* added that "preliminary discussions" can "transition[] to substantive economic negotiations when the parties engaged in a joint exercise to value [the acquirer and target company]." For a discussion of *Flood* and *Olenik*, *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).

The Delaware Court of Chancery ("*Chancery Court*") applied the reasoning of *Olenik* in *Ark. Tchr. Ret. Sys. v. Alon USA Energy, Inc.,* No. 2017-0453-KSJM, 2019 WL 2714331 (Del. Ch. June 28, 2019) ("*Alon USA*"). In *Alon USA*, target management met with the controlling stockholder "six times to discuss potential deal terms," including "deal structure, exchange ratio, and price terms," before the target board formed its independent committee. The *Alon USA* Court ruled that these discussions amounted to premature "substantive economic negotiations" in violation of the ab initio requirement. Accordingly, the defendant directors were denied pleading-stage dismissal. For a discussion of *Alon USA*, *see* Robert S. Reder & Matthew K. Vallade, *Negotiating Against Yourself: Flawed Negotiating Process Leads Chancery Court to Deny M&F-Premised Motion to Dismiss*, 73 Vand. L. Rev. En Banc 213 (2020).

B. Corwin and Trados II

Even in the absence of a controlling stockholder, when a third-party buyout is approved by a target board of directors at least 50% of whose members are interested in the transaction, a Delaware court will apply the entire fairness standard. However, two Delaware decisions effectively bifurcated the Dual Protections of the *M&F Framework* in offering business judgment review of these transactions. *First*, as written in *Salladay* but originally under *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015) ("*Corwin*"), "approval by a fully informed, un-coerced vote of disinterested stockholders can cleanse the transaction—even where entire fairness would otherwise apply," thereby triggering business judgement review. *Second*, as written in *Salladay* but originally under *In re Trados Inc. S'holder Litig.*, 73 A.3d 17 (Del. Ch. 2013) ("*Trados II*"), "a fully-empowered, independent special committee can potentially cleanse the transaction," with similar effect.

C. Salladay

In *Salladay*, the Chancery Court explored the availability of both the *Corwin* and *Trados II* cleansing techniques in the case of a buyout involving a significant target stockholder. Although the plaintiff did not allege that the significant stockholder controlled the target, half of the target board members were clearly interested in the transaction. Vice Chancellor Sam Glasscock III's *Corwin* analysis broke no new

ground, but he did conclude that inadequate disclosures to target stockholders deprived defendants of *Corwin* cleansing at the pleading stage. On the other hand, the Vice Chancellor's discussion of *Trados II* offered an interesting application of the *M&F Framework*'s ab initio requirement. Vice Chancellor Glasscock determined that preliminary discussions of the target board's acceptable range of value undermined the role of an independent committee later established to negotiate the buyout. Because neither *Corwin* nor *Trados II* was available to support pleading-stage dismissal, the Vice Chancellor ruled that entire fairness would be the applicable standard of review.

I. FACTUAL BACKGROUND

A. Intersections Encounters Financial Difficulties

Intersections, Inc. ("*Intersections*" or "*Company*") "provides identity protection software services that help protect sensitive information and data in the virtual world." As of November 2018, 42.7% of the Company was owned by Loeb Holding Corporation ("*Loeb*"), a private equity firm which "co-founded Intersections in 1996" and maintained representation on Intersections' board of directors ("*Board*") through Bruce Lev, Loeb's managing director. Two other members of the six-person Board had significant equity investments: CEO Michael Stanfield, with an 8.7% stake, and David McGough, CEO of a longtime Intersections partner, with a 4.7% stake. The shares owned by minority stockholders were publicly traded on the NASDAQ Stock Market. The Company's Securities and Exchange Commission ("*SEC*") filings characterized the stake controlled by the three directors "as potentially controlling."

After launching a heavily marketed, but ultimately unsuccessful, upgrade to its "flagship product" in 2017, Intersections faced serious "financial difficulties." Accordingly, Intersections "began to look for additional borrowing or stock equity sales to raise capital." To facilitate the search, the Board formed a special committee consisting of the three independent directors ("*Committee*") "to enter due diligence and explore possible financing options." The Company failed to secure financing through June 2018 despite multiple negotiations, including a $3.31 per share unsolicited nonbinding proposal, subsequently withdrawn, from KKR & Co. Inc.

B. iSubscribed Comes to the Rescue

Then, on September 14, iSubscribed Investor Group (together with its acquisition vehicle, "*iSubscribed*"), a private enterprise involved in providing "consumer digital security," approached Intersections with a potential transaction. Initial conversations began with Stanfield, Lev, and the Company's CFO, as well as separate discussions directly with Loeb. "Within a week, iSubscribed entered a non-disclosure agreement and began conducting due diligence." At a meeting held on September 27, Stanfield "effectively told [iSubscribed] that the Intersections Board would be receptive to an acquisition offer of $3.50 to $4.00 per share." Subsequently, Stan, Lev, and McGough each expressed interest in rolling over a "substantial majority" of their Company shares in any transaction with iSubscribed.

On October 5, after receiving an update from management, the Board "reconstituted the Committee, which had been previously abandoned." Four days later, iSubscribed "proposed to acquire Intersections at $3.50 per share" *via* a merger transaction "and provide $30 million of senior secured convertible note financing" upon signing of the merger agreement. The note financing was conditioned on iSubscribed receiving "the right to designate a majority of the members on the Board . . . if the proposed acquisition transaction were terminated." As such, if the merger agreement terminated before a transaction was completed, iSubscribed would own "approximately a 35% ownership position in Intersections" through conversion of its notes. iSubscribed's offer, which was "at the precise bottom of the range Stanfield had suggested," also "contemplated that Stanfield, McGough, and Loeb could roll their equity into the deal" and that Loeb and McGough would exchange previously issued promissory notes for convertible note financing "at a favorable rate." On October 10, on advice of counsel, the Committee "determined that any acquisition would be conditioned on approval by a majority-of-the-minority stockholder vote" of the Company stockholders "not rolling over their shares in the transaction."

When iSubscribed increased its bid to $3.68 on October 11, the Board granted iSubscribed exclusive negotiating rights. Although the Committee "retained a 'nationally recognized investment banking firm' as financial advisor for the proposed transaction," this firm "abruptly terminated the engagement" only days later. The Committee then turned to North Point Advisors ("*North Point*"), who was given only "eight days to review the proposed transaction and provide a fairness opinion." Upon receipt of North Point's opinion, the Committee "recommended approval of all aspects of the Transaction." That same

day, the Board "approved the Transaction at $3.68 per share, just below the midpoint of the range suggested to [iSubscribed] by Stanfield." The Company advised other "potential financing partners," with whom discussions were then underway, that it "was not interested in proceeding with them."

The merger agreement provided for a rollover of significant equity by Loeb (80% of its shares), McGough (68.6% of his shares), and Stanfield (35.7% of his shares). Additionally, Stanfield "received a golden parachute . . . payment of around $5.85 million" and a significant post-closing consulting arrangement. The note purchase agreement signed by Intersections and iSubscribed permitted Loeb and McGough to convert their outstanding notes "into common stock at a price of $2.27 per share," a price significantly below the merger price. For their part, "Stanfield, Loeb, and McGough entered into support agreements to tender their shares and grant proxies to vote their shares in favor of the Merger."

C. Litigation Ensues

On November 29, Intersections filed a Schedule 14D-9 with the SEC ("*Schedule 14D-9*") to provide required disclosures concerning the transaction to Company stockholders. The Schedule 14D-9 allegedly lacked material information concerning iSubscribed's "aggregate ownership percentage following the conversion of its Notes," as well as "how NASDAQ Rule 5640 would apply" to potentially limit iSubscribed's negotiated right to appoint a Board majority. NASDAQ Rule 5640 ("*Rule 5640*") "proscribes appointment powers disproportionate to ownership," which could "potentially limit [iSubscribed] to appointing only a minority of the Board" should it convert its notes into a 35% stock position upon termination of the merger agreement. Further, the Schedule 14D-9 did not disclose "the reason why the first investment bank . . . terminated its engagement several days" after its retention.

Upon expiration of the SEC waiting period following dissemination of the Schedule 14D-9, Loeb, Stanfield, and McGrough acted in their capacities as Company stockholders to approve the merger. Then, in January 2019, Lance Salladay, "a stockholder of Intersections at all relevant times," challenged the transaction by filing a breach of fiduciary duty claim in the Chancery Court against all Board members. After plaintiff "voluntarily dismissed" the claims against the three independent directors, the remaining directors moved to dismiss.

II. VICE CHANCELLOR GLASSCOCK'S ANALYSIS

Crucially, for reasons not addressed in *Salladay*, the plaintiff did not allege that Loeb or the three defendant directors controlled Intersections, despite their effective control of over 50% of Intersections' stock and their characterization in Company SEC filings "as potentially controlling." Thus, there was no need for Vice Chancellor Glasscock to consider the applicability of the *M&F Framework* in considering the defendants' motion to dismiss.

On the other hand, since 50% of the Board's six members—Lev, Stanfield, and McGrough—were undeniably interested in the transaction, the Vice Chancellor explained that entire fairness would be the appropriate standard of review *unless* either *Trados II* or *Corwin* was available to trigger business judgment review. Because the plaintiff adequately alleged infirmities with the Committee process and inadequate Schedule 14D-9 disclosures, neither defense was available, leading the Vice Chancellor to deny the defendants' motion to dismiss. Further, the Vice Chancellor declared that entire fairness would be applicable because the plaintiff's complaint "clears the low hurdle of pleading unfair process and price . . . by adequately alleging that insiders influenced the transaction to divert merger consideration to themselves, and that the Company was sold at an unfairly depressed price."

A. Trados II Not Applicable

Citing *Trados II*, Vice Chancellor Glasscock explained that, even when a transaction is approved by a conflicted board of directors, "a fully constituted, adequately authorized, and independent special committee can cleanse such a transaction . . . because the true empowerment of a committee of independent, unconflicted directors removes the malign influence of the self-interested directors, and thus should result in business judgement review." To determine whether *Trados II* provided relief to the defendant directors, the Vice Chancellor focused on "the timing of the formation of the [C]ommittee." Applying the "same rationale" as drove the decisions in *Flood* and *Olenik*, the Vice Chancellor opined that "the [C]ommittee [must] be sufficiently constituted and authorized *ab initio* . . . consistent, that is, with the requirements set forth in" *M&F*. As such, "[e]ven in a non-control setting, commencing negotiations prior to the special committee's constitution may begin to shape the transaction in a way that even a fully-empowered committee will later struggle to overcome. In that scenario, . . . the existence of the committee is insufficient to replicate

an arms-length transaction." And as the *Olenik* Court clarified, when parties engage in preliminary discussions over valuation before the committee is properly constituted, "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."

Applying the *Olenik* ab initio framework, Vice Chancellor Glascock concluded that "the Committee was not properly constituted from the Merger's inception in a way that could take advantage of the cleansing effect proposed in *Trados II*." Specifically, Stanfield and Lev had significant conversations with iSubscribed before the abandoned Committee was reconstituted. Although the Schedule 14D-9 represented that Stanfield "did not have authority to negotiate on behalf of the Company" and "only gave his personal view of what price the directors would be amenable to," the Vice Chancellor focused on Stanfield telling iSubscribed that the Board would be receptive to an offer between $3.50 and $4.00 per share. Recognizing that these discussions were neither as "extensive" nor as durationally significant as the "preliminary discussions" in *Olenik*, the Vice Chancellor nonetheless found "that at the pleading stage I can infer that . . . these discussions prior to the Committee's reconstitution essentially formed a price collar that 'set the field of play for the economic negotiations to come.' " That iSubscribed's initial offer was at "the exact lower end of Stanfield's suggestion," while the final negotiated price was "just under the middle of the range he provided," "strengthened" this inference. While "[d]iscovery may demonstrate otherwise," the well-pled allegation of "substantive economic negotiations, pre-Committee, . . . raises a pleading-stage inference that these discussions deprived the Committee of the full negotiating power sufficient to invoke the business judgement rule."

B. Corwin Not Applicable

Next, Vice Chancellor Glasscock applied a *Corwin* analysis and concluded that it was "reasonably conceivable" that the Schedule 14D-9 included material misstatements and omissions, making *Corwin* cleansing unavailable at the pleading stage:

- *First*, the Schedule 14D-9 failed to disclose adequately iSubscribed's "[a]ppointment [r]ights if the [s]tockholders [r]eject the [m]erger." Although the information necessary to determine whether Rule 5640 would limit iSubscribed's ability to take control of the Board was scattered throughout the Schedule 14D-9, according to the Vice Chancellor, this "scavenger hunt" approach to disclosure "leaves the stockholder

on her own to look past the impression of a contractual right to control that the 14D-9 creates, and to discern that the application of Rule 5640 might supersede this contractual outcome." Without further clear guidance, "the stockholder must track down stock ownership numbers in the exhibits to complete the analysis," leading to a "plausibly coercive" presentation "not sufficient to meet a fiduciary's disclosure obligations." Further, he found that the "potential that a 'no' vote could lead to ownership of equity in a newly-controlled corporation is material to a stockholder's decision on whether to sell her shares."

- *Second*, the Vice Chancellor found it "reasonably conceivable that missing information regarding the exit of the first financial advisor hired to evaluate the acquisition would have been material to a reasonable stockholder." After all, a "fairness opinion is perhaps the most material factor in a 'sell/don't sell' binary decision . . . ." Defendants argued that this information was immaterial in light of the "extensive disclosures" provided with North Point's fairness opinion. In response, the Vice Chancellor noted that "[t]he [p]laintiff's inference is that the financial advisor found it could not approve the Transaction as it stood and so it walked away, and the Company chose not to disclose its disapproval." Finding a lack of sufficient detail in the Schedule 14D-9 to discern the actual state of affairs, the Vice Chancellor concluded that a "reasonable stockholder" would "want to know why a well-known financial advisor voluntarily terminated an engagement and walked away from a fully formed transaction."

CONCLUSION

Salladay discusses the options available to corporate dealmakers and their legal counsel to obtain business judgment review—and ultimately pleading-stage dismissal—of conflicted transactions. If a controlling stockholder is to receive benefits from the transaction not shared with the other stockholders (e.g., a controlling stockholder-led buyout), *both* an independent board committee *and* obtaining disinterested stockholder approval are necessary to satisfy the Dual Protections of the *M&F Framework*. In the absence of a controlling stockholder but where at least 50% of the target board is interested in the transaction, *either* of *M&F*'s Dual Protections will suffice: (i) fully-informed, uncoerced approval by the disinterested

stockholders under *Corwin*, *or* (ii) approval by a fully empowered, independent board committee under *Trados II*.

In *Salladay*, consistent with the *M&F Framework*, Vice Chancellor Glasscock applied the ab initio requirement in determining whether the Intersections independent board committee was organized and functioning *before* substantive economic negotiations took place. Because the parties discussed an acceptable range of values before the independent committee was up and running, and because the disclosures to stockholders were wanting, the Vice Chancellor denied pleading-stage dismissal to defendant directors under either *Trados II* or *Corwin*.