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Client Alert Commentary

Latham & Watkins Securities Litigation & Professional Liability Practice

May 2, 2019 | Number 2493

Delaware Supreme Court Clarifies *Ab Initio* Requirement Under *MFW*

To obtain business judgment deference, controllers must insist on* MFW's *minority protections before engaging in any substantive economic or valuation discussions.

The Delaware Supreme Court's 2014 decision in *Kahn v. M&F Worldwide Corp.*[1] (*MFW*) altered the landscape for suits challenging controlling stockholder take-private transactions. The decision provided that if a controller conditions the deal on specific minority stockholder protections from the beginning, then the transaction may be subject to the same deferential "business judgment" review that applies to arm's-length, third-party transactions under Delaware General Corporation Law § 251 (8 Del. C. § 251), rather than the more stringent "entire fairness" standard.[2] Questions that have arisen since *MFW* include: when exactly is the "beginning" of a transaction and when does the beginning end? Deal discussions often begin informally or proceed in an on-again, off-again manner, and prior case law was unclear about the precise point in the process when the controller needed to insist upon *MFW*'s minority protections in order for the transaction to obtain business judgment deference.

The Delaware Supreme Court's April 5, 2019, decision in *Olenik v. Lodzinski*[3] provides some much-needed clarity to that timing issue. Earlier cases held that the *MFW* protections must be in place before any "substantive economic negotiations" took place, but *Lodzinski* expands upon that standard and explains that early exploratory discussions about ranges of value, or intentions to make future offers, may trigger the need for the protections to be in place even if no firm offer is on the table at such time. Controllers, target companies, and the targets' special committees must be familiar with *Lodzinski* because once substantive economic negotiations begin, it is probably too late to put the *MFW* protections in place. Implementing the protections at the right time can be the difference between a pleadings stage dismissal (under the business judgment standard) and a full trial (under the entire fairness standard that otherwise applies to transactions with controllers).

Controlling Shareholder Buy-Out: The Road to *MFW*

Under Delaware law, a controlling stockholder's buy-out of the company's minority interests was historically reviewed under the rigorous entire fairness standard given that controllers, by definition, control the company and can impose their will over the objection of the minority. Even if a special committee of disinterested directors approved the deal, or if the deal was subject to a vote of the minority stockholders, the burden of proof would, at most, shift from the defendant to the plaintiff — and the standard would still be whether the deal was "entirely fair" to the minority stockholders. Given the fact-

specific nature of the fairness inquiry, if that standard applied, a pleadings-stage dismissal was very unlikely. The law therefore provided little incentive for controllers to condition deals on minority stockholder protections, because even if they did, they would likely either have to pay to settle claims challenging the transaction's fairness, or undergo extensive litigation and potentially a full trial to prove the fairness of the deal.[4] The unfortunate consequences of this state of law were that (i) no matter how favorable the deal was for minority stockholders, the deal would likely trigger litigation, and (ii) every such suit carried automatic settlement value.

The law changed with *MFW* and its progeny. In *MFW*, the Delaware Supreme Court reasoned that a controller could mirror a third-party, arm's-length merger under 8 Del. C. § 251 by irrevocably subjecting a transaction to two specific minority protections from the outset of the negotiations: (i) an empowered, independent special committee;[5] *and* (ii) the informed, uncoerced consent of a majority-of-the-minority stockholders.[6] The Court reasoned that if these conditions were in place *ab initio*, the controller would have sufficiently "disabled" itself from unfairly influencing the transaction. With the removal of the controller's thumb from the scale, minority stockholders would have the same general protections as stockholders in a third-party merger offer. Thus, the Court saw no reason why a transaction with a properly disabled controller should be treated any differently than a third-party deal, and therefore concluded that, if *MFW*'s conditions were satisfied, deferential business judgment review would apply.[7]

Initially it was unclear whether *MFW* could be applied at the pleadings stage, but subsequent Delaware Supreme Court cases have confirmed that it can.[8] *MFW* has become a powerful tool in deal structuring, providing concrete incentives for controllers to disable themselves when negotiating with minority stockholders (or disinterested special committees representing them) in return for gaining a reduced likelihood of suit, and the potential early dismissal of any such action. Since *MFW*, Delaware courts have repeatedly applied the *MFW* standard to deliver pleadings-stage dismissals.[9]

What Is *Ab Initio* and When Does It End?

Since *MFW*, courts and litigants have grappled with how early the controller must disable itself by insisting upon the *MFW* protections. The Delaware Supreme Court made clear that the controller cannot use those protections as a bargaining chip in the negotiations: from inception, the controlling stockholder must know that it cannot bypass the special committee's ability to say no and cannot "horse trade" by offering minority protections later in the process in exchange for concessions.[10]

For example, in the first case to apply *MFW* at the pleadings stage, *Swomley v. Schlecht*, the Delaware Court of Chancery noted that the controller's initial proposal "hedged" on whether the majority-of-the-minority condition would be waivable or not.[11] However, the court nonetheless found the *ab initio* requirement satisfied because the target's board resolved, at its very first meeting after receiving the offer, that any deal would require both a special committee's approval and a majority-of-the-minority vote. Thus, the court was satisfied that the *MFW* conditions were in place *ab initio,* noting "[a]ll this went down before any negotiations took place, even before anything really started."[12] The Delaware Supreme Court affirmed without opinion.[13]

The court in *Flood v. Synutra Int'l, Inc.* subsequently elaborated upon the "before any negotiations" standard set out in *Swomley*.[14] In *Synutra*, the initial letter of interest from the controlling stockholder did not contain *MFW*'s dual protections.[15] However, once a special committee had been formed, a second letter of interest issued two weeks later preconditioned the deal on the *MFW* protections.[16] The Delaware Supreme Court noted that the special committee declined to engage in any price negotiations until the committee's banker could perform due diligence, and no price negotiations took place until seven months after the *MFW* conditions were in place.[17] Chief Justice Strine, writing for the majority, found that the

controlling stockholder had successfully conditioned his offer "at the germination stage" and "self-disable[d] before the start of substantive economic negotiations."[18]

In a dissent, however, Justice Valihura advocated for a more bright-line standard: controlling stockholders must include the *MFW* conditions in the initial proposal itself.[19] Justice Valihura opined that any doubt as to whether the *MFW* protections were implemented in a timely fashion should be resolved against the controller.[20] She reasoned that a bright-line rule makes sense in the context of a controlling stockholder take-private transaction, because the controller has the power to decide when to (i) begin negotiations, and (ii) insist upon the *MFW* conditions.[21] She posited that a bright-line rule serves the underlying purpose of a speedy determination of the proper standard of review at the pleadings stage, while a vague standard requiring the *MFW* protections to be in place before any negotiations occur invites a judicial investigation into a "factual morass" that is inappropriate at the pleadings stage. [22]

Olenik v. Lodzinski — Clarifying Timing Under *MFW*

This debate crystalized in the Delaware Supreme Court's April 5, 2019 ruling in *Lodzinski*. In this case, EnCap Investments L.P. (EnCap) owned 96% of one company, Bold Energy III LLC (Bold), and also a majority stake in an entity that owned 41% of Earthstone Energy, Inc. (Earthstone).[23] Earthstone, led by its CEO and Chairman, Mr. Frank Lodzinski, was a mature-stage company operating in the upstream oil and gas sector in Texas, but with limited undeveloped resources. Bold was an early-stage oil and gas company with premium undeveloped acreage in Texas's oil rich Midland Basin, but with limited resources to drill and extract its holdings. In addition, EnCap, Bold's financial sponsor, had reached the end of its financial commitments in the summer of 2015 and was reluctant to invest more capital in the company. The parties began discussing a combination transaction in the fall of 2015, and eventually consummated a stock-for-stock deal in November 2016 that gave Earthstone stockholders 39% and Bold stockholders 61% of the equity of the combined entity.[24] The combination offered a premium for Earthstone stockholders based on the company's trading price before the merger announcement, and Earthstone's stock jumped 27% on the day of the announcement. Ultimately, 99.7% of Earthstone's minority stockholders who voted on the transaction approved the deal. A group of dissenting stockholders brought a class action suit in Delaware Chancery Court, claiming an unfair price. The Chancery Court dismissed the case on the grounds that the *MFW* conditions had been satisfied and the transaction passed muster under the business judgment standard of review.[25] Plaintiffs appealed.

Plaintiffs alleged that, during the negotiations, Bold's parent, EnCap, had sought to take Bold public or sell the company or its assets, as early as June 2015, but a market check at the time came up empty. Upon hearing of Bold's unsuccessful efforts, Mr. Lodzinski initiated discussions with EnCap for an acquisition of Bold's assets in the fall of 2015. Between November 2015 and January 2016, Earthstone engaged in an extensive review of Bold's assets, and even sought valuation parameters from three separate investment banking firms. By April 27, 2016, Mr. Lodzinski felt confident enough to send a letter to the Earthstone Board of Directors stating that he was "updating [his] analysis" on Bold and that he "intend[ed] to make an offer."[26] This letter did not mention the *MFW* minority protections. The Supreme Court's unanimous opinion noted this omission, stating that "EnCap, Earthstone, and Bold were engaged in substantive economic discussions … eight months before the *MFW* protections were put [in] place."[27]

In May 2016, without engaging an independent financial advisor, Earthstone made two presentations to EnCap regarding a potential combination between Earthstone and Bold. Earthstone's first presentation valued Bold at US$305 million. When EnCap apparently did not respond to this presentation after a week, Earthstone made a second presentation that valued Bold at US$355 million. Once again, neither presentation mentioned the *MFW* minority protections. The Court identified these valuations as the discernible dividing line at which discussions transitioned from "preliminary discussions ... to substantive

economic negotiations when the parties engaged in a joint exercise to value Earthstone and Bold."[28] The valuations were particularly probative because "[b]ased on these facts, it is reasonable to infer that 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."[29]

On July 8, 2016 — more than two months after Mr. Lodzinski's initial letter to the Earthstone Board, and more than eight months after his initial discussions with EnCap — Earthstone's two independent directors began taking steps to form a special committee to oversee the transaction. Earthstone's Board did not actually form the special committee until July 29, 2016. When Earthstone made its first formal proposal to Bold on August 19, 2016, the proposal conditioned the transaction on the *MFW* protections for the first time. The offer was for an all-stock transaction valuing Bold at US$325 million — well within the range set out in the May valuations.

The Appellees contended that they satisfied *MFW* because the first binding offer was conditioned on the *MFW* protections, and they discounted the prior discussions as merely exploratory discussions that did not rise to the level of the substantive economic negotiations standard enunciated in earlier Delaware case law. The Delaware Supreme Court disagreed, given the advanced nature of the economic discussions that occurred. The Court instead concluded that the Appellant "ha[d] pled facts that support[ed] a reasonable inference that the two procedural protections were not put in place early and before substantive economic negotiation took place."[30] The Chancery Court's dismissal on *MFW* grounds was overturned.

Best Practices for Controllers Engaging in Take-Private Transactions

If a controlling stockholder engages in a take-private merger (or other transaction over which the stockholder can exert substantial influence), and wants to have the transaction reviewed under the deferential business judgment standard rather than the much more stringent entire fairness standard, the controller should condition the transaction on the *MFW* protections from the very first discussion or initial offer. As Justice Valihura observed, the controller has total authority over when the merger discussions commence and is uniquely empowered to condition any negotiations on these protections. If pre-negotiation disablement is, for whatever reason, not feasible, *Lodzinski* requires a controller to insist on the *MFW* protections before the controller commences substantive negotiations in order to obtain the benefit of the business judgment standard.

Lodzinski, like *Synutra* before it, seems to indicate that, to obtain the benefit of the business judgment standard, a controller only need insist that the transaction be subject to the *MFW* protections, not that the protections actually be in place before the start of negotiations. However, the logical interpretation of these decisions is that a controller wishing to have the benefit of the protections cannot commence substantive negotiations until the party charged with protecting minority stockholders' interests (usually a committee of the target company's board composed of disinterested directors) have agreed to and implemented the protections. Courts look at substance rather than form in determining what constitutes substantive discussions. Thus, even if a controller does not make a binding, written offer that the other party can accept, if the controller engages in exploratory talks about economic value, terms, or the structure of a transaction that arguably have the effect of narrowing the negotiating range, the controller runs the risk that the court will find that *MFW* protections should have been in place before those discussions began. *Lodzinski* indicates that valuation discussions can be tantamount to substantive economic negotiations, particularly if they set the parameters for subsequent economic negotiations. Controlling shareholders cannot circumvent the procedural safeguards of *MFW* by nominally offering the *MFW* conditions after negotiations are well under way, or after the economic goalposts have effectively been narrowed.

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Endnotes

[1] 88 A.3d 635 (Del. 2014).

[2] *Kahn v. Lynch Commc'n Sys*., 638 A.2d 1110, 1117 (Del. 1994) ("[T]he exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness.").

[3] No. 392, 2018, 2019 WL 1497167 (Del. Apr. 5, 2019).

[4] *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983); *Kahn v. Lynch Commc'n Sys*., 638 A.2d 1110 (Del. 1994). *Kahn v. Lynch* established that steps to protect minority interests could, at best, result in burden shifting at trial.

[5] The Court listed requirements to ensure that the special committee was properly empowered, such as being able to hire its own advisors, negotiate with the controller, and definitively reject any offer from the controller and end the negotiations. *MFW*, 88 A.3d at 645.

[6] 88 A.3d at 645.

[7] *Id.* at 644-45.

[8] *See, e.g.*, Daniel Gold and Scott Ewing, *New Guidance on How MFW Operates at Pleading Stage*, LAW360 (Sept. 10, 2014, 10:55 AM), https://www.law360.com/articles/575685/new-guidance-on-how-mfw-operates-at-pleading-stage.

[9] *See, e.g.*, *In re Books-A-Million, Inc. S'holders Litig.*, C.A. No. 11343-VCL, 2016 WL 5874974 (Del. Ch. Oct. 10, 2016), ***aff'd***, 164 A.3d 56 (Del. 2017) (Table); *Swomley v. Schlecht*, C.A. No. 9355-VCL (Aug. 27, 2014) (Transcript Ruling), ***aff'd***, 128 A.3d 992 (Del. 2015) (Table).

[10] *In re MFW S'holders Litig.*, 67 A.3d 496, 528 (Del. Ch. 2013); *Flood v. Synutra Int'l, Inc.*, 195 A.3d 754, 756 (Del. 2018).

[11] C.A. No. 9355-VCL (Aug. 27, 2014) (Transcript Ruling), ***aff'd***, 128 A.3d 992 (Del. 2015).

[12] *Id*.

[13] *Id*. Similarly, in *In re Books-A-Million, Inc. S'holders Litig.*, the controller conditioned any transaction on the *MFW* dual protections in the initial proposal, leading the court to commend that the controller did not "delay[] establishing the conditions, waver[] from them, or … [seek] to circumvent them." 2016 WL 5874974, at *8.

[14] 195 A.3d 754 (majority opinion).

[15] *Id*. at 757.

[16] *Id*. at 758.

[17] *Id*.

[18] *Id.* at 763.

[19] *Id.* at 768 (Valihura, J., dissenting)

[20] *Id*. at 779-80.

[21] *Id*.

[22] *Id*. at 776, 779-80.

[23] Appellees argued that EnCap's 41% stake did not qualify it as a controlling stockholder, but the Delaware Supreme Court rejected this argument due to facts pleaded in the complaint that supported the Appellants' control theory. *Lodzinski*, 2019 WL 1497167, at *10.

[24] The deal structure in the Earthstone/Bold transaction was not a classic take-private by a controlling stockholder. The two principal parties to the business combination (Earthstone and Bold) were directly or indirectly controlled by the same parent entity (EnCap), and the *MFW* issue arose in the context of the fairness of the transaction to Earthstone's minority stockholders. The Court noted that "[a]lthough the Earthstone/Bold transaction is not a transaction between the controlling stockholder and a controlled company, the same principles apply whether the controller is directly or indirectly exerting its influence over the transaction." *Lodzinski*, 2019 WL 1497167, at *7 n.50.

[25] *Olenik v. Lodzinski*, No. CV 2017-0414-JRS, 2018 WL 3493092 (Del. Ch. July 20, 2018).

[26] *Lodzinski*, 2019 WL 1497167, at *3.

[27] *Id.* at *10.

[28] *Id.* at *9.

[29] *Id*. The Court noted that this is what essentially transpired under the facts as alleged.

[30] *Id.* at *10.