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Decision Highlights Risk a Controller's Direct Discussions With Minority Stockholders May Render MFW *Unavailable*–In re HomeFed

In *In re HomeFed Corporation Stockholder Litigation* (July 13, 2020), the Delaware Court of Chancery held that the going-private transaction involving HomeFed Corporation (the "Company") and its controlling stockholder, Jefferies Financial Group Inc., did not meet the prerequisites, under *MFW*, for business judgment review. Chancellor Bouchard, at the pleading stage of the litigation, found that it was reasonably conceivable that *MFW*'s "*ab initio*" requirement had not been met–that is, that the controller had not conditioned the proposed transaction on approval by both an independent special committee and a majority of the minority stockholders before the controller engaged in "substantive economic negotiations." Chancellor Bouchard rejected the defendants' motion to dismiss and ruled that the transaction will be reviewed under the more stringent entire fairness standard.

Key Points

- **The decision amplifies the court's recent focus on direct discussions between a controller and minority stockholders as a basis on which *MFW* business judgment review may be rendered unavailable.** The court's discussion suggests that direct communications between a controller and minority stockholders, whether they occur *before or after* the *MFW* conditions are put in place, may be problematic for *MFW* purposes, as they may interfere with the special committee's effective functioning in negotiating the transaction on behalf of the minority stockholders as contemplated by *MFW*. The court also found in its recent *Dell Technologies* decision that direct discussions between a controller and minority stockholders (in that case, *after* the *MFW* protections were in place) may have indicated that the special committee did not function effectively for *MFW* purposes.

- **The decision emphasizes the importance of the special committee's role in "disabling" a controller's influence.** The court stressed in *HomeFed* that *MFW* contemplates that the special committee will be the "independent bargaining agent" for the minority stockholders. Both *HomeFed* and *Dell Technologies* suggest that the court may view a committee's failure to do so as an important factor in determining whether the committee "functioned effectively" for purposes of satisfying the prerequisites for *MFW* availability.

- ***HomeFed* and *Dell Technologies* reach unsurprising results, but may reflect a trend toward a more stringent approach by the court in determining *MFW* (and *Corwin*) applicability.** These decisions can be viewed as routine decisions finding the *MFW* prerequisites to business judgment review unsatisfied. At the same time, in our view, they possibly may suggest a generally more

restrictive ongoing trend than had previously been the case with respect to the availability of business judgment review under *MFW* (or, in the *non*-controlled company context, under *Corwin*).

Background. In 2017, one of the Company's independent directors suggested to Jefferies, the Company's 70% stockholder-controller, that Jefferies acquire the other 30% of the Company's shares by exchanging two Jefferies shares for every Company share held by the minority stockholders. Jefferies responded that it was interested in pursuing such a transaction. In December 2017, the Company established a Special Committee to negotiate with Jefferies on behalf of the minority stockholders. The resolutions creating the Committee directed the Company's officers not to discuss a potential transaction with anyone other than the Committee unless the Committee Chairman had approved of or was present for the discussions. In March 2018, Jefferies told the Committee that it was no longer interested in pursuing a transaction. At this time, the 2:1 exchange ratio implied a value per Company share that represented a negative 13% premium for the minority stockholders. Although Jefferies had communicated that it was no longer interested in a transaction, from March 2018 through January 2019 it engaged in discussions with the Company's largest minority stockholder, Beck, Mack and Oliver LLC ("BMO"), which owned 36% of the minority shares (and whose support was thus essential to accomplishing any transaction requiring minority stockholder approval). In early February 2019, BMO told Jefferies it would support a 2:1 share exchange; the Committee learned that the Jefferies-BMO discussions had taken place and "reactivated" its process; and Jefferies (whose stock price had been declining) formally proposed the 2:1 share exchange, conditioned on approval by a special committee and a majority of the minority stockholders. The Committee made a counterproposal for a fixed value cash offer, which Jefferies rejected. The Committee then negotiated the addition of a collar and a cash alternative election for the stockholders. A merger agreement was signed and publicly announced. BMO, and the next largest minority stockholder (with an almost 10% interest), voiced objection to the proposed transaction and the Committee granted them permission to negotiate directly with Jefferies. Through these negotiations, the collar and the cash alternative were eliminated. The Committee then approved an amended agreement for a 2:1 share exchange, which subsequently was implemented (the "Transaction").

Certain former minority stockholders filed a post-closing fiduciary suit against the Committee directors and Jefferies. The defendants moved to dismiss on the basis that *MFW* applied and the Transaction therefore was subject to business judgment deference. Chancellor Bouchard held, at the pleading stage, that it was reasonably conceivable that the Transaction did not satisfy *MFW*'s *ab initio* requirement.

***MFW*.** Under *MFW*, in a post-closing challenge to a transaction involving a company's controlling stockholder, the standard of judicial review will be the deferential business judgment rule, rather than the stringent entire fairness standard, *if* the transaction was "conditioned *ab initio* [(*i.e.*, from the outset of the process)] upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders." With these protections in place, the court emphasized in *HomeFed*, a controller "irrevocably and publicly disables itself from using its control to dictate the outcome of the negotiations" with respect to its proposed transaction.

Discussion

In both *HomeFed* and *Dell Technologies*, numerous factors indicated that the *MFW* prerequisites may not have been satisfied. In *HomeFed*, as noted, the *MFW* protections apparently were not in place when the controller engaged in "substantive economic discussions" regarding the proposed transaction. Indeed, the *MFW* conditions were not imposed until BMO (which owned 36% of the minority shares) told

Jefferies that it would support the transaction at the proposed exchange ratio–in other words, the minority stockholder approval condition was not imposed until Jefferies had assurance it would be satisfied. In addition, in the court's view, the direct discussions by Jefferies with BMO undermined the effectiveness of the special committee in effectively negotiating the transaction on behalf of the minority stockholders. Indeed, the committee itself viewed the discussions as so problematic when it learned of them that it considered excluding BMO from the minority stockholder vote (although it ultimately determined not to do so). In *Dell*, the controller allegedly repeatedly threatened that, absent approval by the special committee and the minority stockholders, it would implement unilaterally an alternative transaction that would be even less attractive to the minority stockholders. In addition to this apparent coercion, once the minority stockholders objected to the proposed transaction, the special committee completely "abdicated" its negotiating role. Thus, the court's findings in *HomeFed* and *Dell* that *MFW* business judgment review was unavailable is unsurprising.

However, these decisions possibly may reflect a trend of the court toward a more stringent approach generally to *MFW* applicability. While *HomeFed* and *Dell* can be read as routine *MFW* decisions, in our view, the language, tone and approach taken in both opinions suggest that these decisions may reflect the more general trend we have observed toward the court's applying a more searching lens than in the past when determining the availability of *MFW* (or, in the non-controled company context, *Corwin*) business judgment review. We note that, in *Dell*, first, Vice Chancellor Laster appeared to go out of his way to address almost every one of the plaintiff's many arguments supporting the unavailability of *MFW*–and found that each of them, standing alone, would render *MFW* inapplicable. Typically, the court, having found a single basis on which *MFW* was inapplicable would not review other possible bases. Second, in *Dell*, the court appeared to put extra emphasis on the low standard that applies (at the pleading stage) for determining *MFW* applicability–that is, whether there is "any possible inference" that the *MFW* requirements may not have been met. Third, in *Dell*, the court found, without much discussion, that the special committee directors may have breached their duty of loyalty to the minority stockholders by having "catered to" the controller. In *HomeFed*, we observe that the court concluded, with minimal analysis in our view, that the HomeFed special committee directors may have been non-independent and motivated by loyalty to the controller. This conclusion rested on the directors' employment or consulting arrangements with the Company or the controller, but without the usual consideration as to whether those arrangements were material to the directors. We note that some commentators have expressed the view that *MFW* and *Corwin* represented *over*-corrections to the problem they were intended to address (namely, the prevalence of litigation challenging M&A transactions), and that they have, inappropriately, provided "cleansing" for some transactions that involved egregious fact situations. See here our memorandum, *Court of Chancery Amplifies the* MFW *Prerequisites (and May Portend a New Approach to* MFW *and* Corwin*?)*–Dell Technologies (June 30, 2020); and here, our article, *Where Things Stand at Year-End 2019–Possible Retrenchment of the* Corwin *Doctrine* (Winter 2019).

The court emphasized the critical importance for *MFW* purposes of a special committee's acting as the negotiating agent for the minority stockholders and functioning effectively. In both *HomeFed* and *Dell*, the court focused on the special committee as the vehicle through which a controller "self-disables" from being able to dictate the terms of its own transaction. In *HomeFed*, the court stressed the committee's role, as contemplated under *MFW*, as the "independent bargaining agent" for the minority stockholders. A special committee is "uniquely qualified" for this role, the court reasoned, because directors have "superior access to internal sources of information," "owe fiduciary duties" to the minority stockholders, and "do not suffer from the collective action problem of disaggregated stockholders." By

contrast, a minority stockholder, when negotiating with the controller, is typically "unencumbered by fiduciary duties" to, and "may have divergent interests" (economic or otherwise) from, the other minority stockholders. In *HomeFed*, the terms of the transaction were determined in the discussions between Jefferies and BMO that occurred without the Committee's knowledge and after the Committee had "paused" its process; and, we note, although the Committee later negotiated a collar and a cash alternative, those terms were eliminated in direct discussions that the Committee permitted between Jefferies and BMO. As a result, although the court did not directly state as much, the Committee did not appear to function effectively in negotiating the Transaction. In *Dell*, the court's conclusion that the Dell special committee had not functioned effectively was based on the controller's alleged coercive threats and reinforced by the committee's having "wholly abdicated" the negotiations to the minority stockholders after they objected to the terms that had been negotiated and recommended by the committee. Thus, in both cases, the court viewed the controller's actions as having potentially undermined the ability of the special committee to negotiate effectively on behalf of the minority stockholders.

The court suggested that direct discussions between a controller and minority stockholders may be problematic whether it occurs *before or after* the *MFW* protections are in place. In *HomeFed*, the court specifically rejected the defendants' position that "substantive economic discussions *preceding* invocation of *MFW*'s twin protections should not preclude a pleading stage dismissal under *MFW* if they occur between the controller and a minority stockholder with no authority to bind the company as opposed to an authorized representative of the controlled company" and has "no authority to bind the company." The Chancellor observed that neither party provided any legal authority addressing "this precise scenario"–and that in *Dell* the court held that the defendants in that case were not entitled to receive a pleading-stage dismissal under *MFW* "where the controller bypassed the special committee in favor of direct negotiations with stockholders *after* invoking *MFW*'s protections." The Chancellor noted the fundamental principle underlying *MFW* availability that a controller "disable [its control] and negotiate with an independent and adequately empowered committee of directors under the pressures of the dual [*MFW*] protections." If the controller does so, it is entitled to a pleading-stage dismissal of a case that otherwise would be subject to entire fairness review. The Chancellor concluded: "To my mind, it would be imprudent to endorse a rule that would allow a controller to undermine the effectiveness of a special committee *preemptively* through direct negotiations with a stockholder under the circumstances plead here as much as it would be to do so after the committee has been authorized formally."

While the court did not state as much, clearly not all discussions with minority stockholders under all circumstances will necessarily be problematic for *MFW* purposes. Rather, the determination should depend on the specific facts and circumstances. In *HomeFed*, the discussions involved "substantive economic negotiations," with BMO indicating its support of the Transaction at a specified exchange ratio–which was the same ratio that Jefferies originally had proposed. Further, there was contemporaneous evidence that BMO and other minority stockholders thought the ratio was inadequate and supported the Transaction only because they viewed it as "superior to the status quo." In this connection, the Plaintiffs also alleged that the Committee's financial advisor had not adequately analyzed the value of the Jefferies' shares. In addition, the court viewed the Committee as possibly not independent of Jefferies–and, as noted above, the independent members of the Committee *themselves* viewed the Jefferies-BMO discussions as so problematic that they considered excluding BMO from the minority stockholder vote. In *Dell*, the *MFW* protections were in place *before* the controller-minority stockholder discussions took place, but the court nonetheless found them problematic for *MFW* purposes because, after they began, the committee "completely abdicated" its negotiating role. The court commented that, while the deal terms negotiated by the minority stockholders were improved, they were

not necessarily "fair" or as good as they could have been if the committee had not abdicated its role. Moreover, the key issue in *Dell* was that the controller may have coerced the committee and the stockholders by threatening to implement an alternative, highly unfavorable transaction. We would counsel that whether direct discussions with minority stockholders would be problematic for *MFW* purposes will depend on factors such as the timing of the discussions, the substance of the discussions, the size of the minority stockholders' interests, the independence of the special committee, the role the special committee played, the extent of the special committee's involvement in the discussions, and the ultimate terms of the transaction.

The court found that the Special Committee's process was a "continuation" of its consideration of the initial proposal for a transaction rather than an evaluation of a *new* proposal. The *HomeFed* defendants' position that the *ab initio* requirement had been satisfied was based on their view that the Committee's work in April 2019 was separate from the work it had done from December 2018 through March 2019 when a possible Jefferies buyout of the minority was first discussed and the Committee had been established. The defendants cited *Books-a-Million*, where the court had found that it was not reasonably conceivable that "a proposal from a controller made nearly three years after a special committee rejected an initial proposal from the controller containing a different price and different terms was a continuation of the first proposal." In contrast with *Books-a-Million*, however, in *HomeFed*, as the court noted: (i) the Company's board never repealed the December 2017 resolutions establishing the Committee nor at any point dissolved the Committee; (ii) the Company's board minutes and proxy statement reflected that the Committee had "only determined to ***pause*** its process…when Jefferies indicated it no longer wanted to pursue a transaction"; (iii) Jefferies had "repeatedly" held substantive economic discussions concerning a potential buyout over the next eleven months with BMO notwithstanding that the Committee was given the exclusive authority to communicate with the minority stockholders; and (iv) those discussions culminated in BMO expressing support for a transaction with the same exchange ratio initially proposed by Jefferies which had "triggered the need for the Special Committee in the first place." The court commented that its conclusion on this issue was irrelevant to its holding because, even if one considered the Committee's work to be related to a *new* proposal, "substantive economic discussions" still had taken place prior to the new proposal having been subjected to the *MFW* conditions.

Discussions concerning the exchange ratio constituted "substantive economic discussions." The court stated in *HomeFed* that Jefferies' discussions with BMO included discussion of "the key economic term of the Transaction–the price." The court wrote: "One would be hard-pressed not to view the exchange ratio as an important substantive economic term….In fact, the 2:1 ratio to which BMO indicated support just days before Jefferies purported to commit itself to the *MFW* protections ultimately dictated the final price [the] minority stockholders received for their shares in the Transaction a few months later." The court also noted that Jefferies, when it rebuffed a fixed value counteroffer that that the Special Committee made, cited BMO's support for a 2:1 exchange ratio.

The court found it reasonably conceivable that two of the HomeFed directors may not have been independent and thus may have acted to advance the self-interest of the controller. The court concluded that, when viewed collectively, the Plaintiffs' allegations supported a rational inference that two of the members of the HomeFed board could not be presumed to have been acting independently from Jefferies and may have "acted to support [Jefferies'] self-interest by approving the Transaction." The court therefore refused, at the pleading stage, to dismiss fiduciary claims against these directors under *Cornerstone*. The court reasoned that, in addition to other ties to the Company and Jefferies: (i) one of

the directors was serving as an executive officer of the Company; (ii) the other had been receiving consulting fees from the Company, as his sole employment apart from serving as a Company director for years (and as recently as about one month prior to the vote); and (iii) certain of these directors' fellow directors had questioned their independence from Jefferies. We observe that the consulting fees could be viewed as having been relatively modest and the court did not address the materiality of the employment and consulting arrangements (except to state that the consulting and board service constituted the only employment of one of the directors).

Practice Points

- **A controller seeking to structure a proposed transaction to comply with *MFW* should consider not having, or should limit, direct discussions with minority stockholders.** Clearly, the safest course for ensuring *MFW* compliance would be for a controller to impose the *MFW* conditions as early as possible in the process and not to have direct discussions with the minority stockholders. As discussed above, however, whether such discussions would be problematic for *MFW* purposes will depend on the overall context. Generally, discussions that do not constitute "substantive economic negotiations" or that occur *after* the *MFW* protections are in place should not be problematic if the committee members are independent and the committee follows appropriate procedures and functions effectively. ***A controller should:*** evaluate and weigh carefully the risks and potential benefits of engaging in discussions with minority stockholders; consider not engaging in such discussions without first obtaining the special committee's permission; and consider including a special committee member or advisor in (or keeping them informed of) any such discussions. ***A special committee should:*** maintain involvement in or oversight of (and, if possible, set parameters for) any discussions between the controller and minority stockholders; not abdicate its negotiating role if the minority stockholders object to the terms it recommends (but instead return to the bargaining table to try to obtain a deal that the stockholders would support); consider how it might negate an attempt by the controller to be coercive; and keep in mind the leverage it has from the power to "say no." ***A board should:*** appoint to a special committee directors who will be viewed by the court as independent and disinterested.

- **A special committee should seek to provide clarity as to whether its consideration of a proposal is or is not part of a previous process considering the same or a similar proposal.** If a controller ceases to have interest in a proposed transaction, and its interest later is renewed, the committee should be careful to establish a record as to whether its evaluation is a continuation of the previous process or the beginning of a new process. That record may be critical in a court's determination whether the transaction was subject, *ab initio*, to the *MFW* conditions.

- **Financial advisors evaluating a proposed share exchange should consider relying on more than just the trading price of shares to analyze the value of the exchange shares.** The court recited in the factual background of the *HomeFed* transaction the Plaintiffs' complaint that, when valuing the Jefferies shares, the financial advisor to the Special Committee relied exclusively on the trading price of the shares and did not conduct any other analyses of Jefferies' value or consider projections of its future performance.

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