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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Delaware Decision Clarifies MFW's Ab Initio Requirement

By **Gail Weinstein, Robert Schwenkel, Steven Epstein and Brian Mangino**
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Gail Weinstein



Robert Schwenkel



Steven Epstein



Brian Mangino

MFW provides for judicial review of a merger between a controller and the controlled company under the deferential business judgment rule standard (rather than "entire fairness") if, among other things, "from the outset of negotiations" (the so-called "ab initio requirement"), the controller conditioned the transaction on approval by both an independent special committee and a majority of the minority stockholders. A July 20 decision in Olenik v. Lodzinski is notable for providing a substantial discussion of the difference between "negotiations" and "preliminary discussions" for purposes of determining whether this requirement has been met. The factual context involved an all-stock merger between two companies (one of them, a financially troubled company) that had a common purported controller, a lead negotiator for the acquiring company who was the CEO and had a financial interest in the controller, and an equity split that provided the acquiring company with a smaller equity interest in the resulting entity than was supported by the contribution analysis prepared by the special committee's banker.

Key Points

The court found that MFW applied even though there had been "extensive preliminary discussions" before the MFW-required conditions were imposed by the buyer.

The court held that, notwithstanding 10 months of discussions, for MFW purposes, the "negotiations" did not begin until the buyer submitted a "definitive proposal" (in the form of a formal offer letter). The court distinguished (a) "exploratory discussions" (even if "extensive") to determine whether a proposal would be made from (b) "negotiations" to reach a definitive agreement after a proposal has been made. Importantly, the factual context included (1) no evidence of significant price discussions having occurred during the 10 months of discussions preceding the offer letter; (2) two months of back-and-forth negotiation over pricing (i.e., the equity split) following submission of the offer letter; and (3) a special committee that the court viewed as having been independent and having functioned effectively.

In our view, the decision indicates that the court is not likely to find MFW inapplicable based on the ab initio requirement when the other MFW requirements have been satisfied.

The court's discussion of the distinctions between "discussions" and "negotiations," while providing helpful guidance, does not establish a clear dividing line between the two. However, we believe that the decision indicates that, in general, the court will tend to disfavor a finding that MFW is inapplicable based on the ab initio requirement, at least where (1) the minority stockholders approve the transaction (which, in this case, they did overwhelmingly), (2) the special committee functions effectively in overseeing the process and does not "rubber-stamp a fully-baked deal," and (3) the initial discussions do not appear to involved a tradeoff where the controller agrees to accept the MFW approval conditions in exchange for a lower price.

The decision indicates that, depending on the facts and circumstances, there is some leeway for controllers in terms of their timing in determining whether or not to structure a transaction to be MFW-compliant.

We note, however, that the critical factor in most cases when a determination is made whether to structure a transaction to be MFW-compliant is not related to the strictures of the ab initio requirement but to the uncertainty for the transaction created by the minority stockholder approval condition.

Notably, the court did not find it problematic that the lead negotiator for the buyer had significant ties to the controller.

The court stated that, given the CEO's track record and expertise in the industry, it was unsurprising that he would be selected as the lead negotiator (notwithstanding his conflicts). We note again that the overall factual context included, in the court's view, an effectively functioning special committee that actively oversaw the process.

Background

Earthstone Energy Inc., a company operating in the "upstream" oil and natural gas sector, acquired Bold Energy LLC pursuant to an all-stock merger, with the Earthstone and Bold legacy stockholders ending up owning about 39 percent and 61 percent, respectively, of the combined company. At the time that discussions between the two parties began, EnCap Investments LP, a private equity firm, beneficially owned about 41 percent of Earthstone (through its EnCap's controlling interest in Oak Valley Resources LLC, a holding company for oil and gas investments) and also owned about 96 percent of Bold. The Earthstone board was comprised of nine directors, seven of whom had been appointed by Oak and five of whom were senior executives of Earthstone and/or were serving on the boards of and/or held membership units in Encap and/or Oak. The CEO of Earthstone, who was also a director (and who had a financial interest in and extensive connections with Oak) served as Earthstone's lead negotiator throughout the process.

Preceding the discussions, Earthstone had pursued a year-long "acquisition spree" that created significant value for the company; EnCap was reaching the end of its capital commitment to Bold; and Bold had conducted an "extensive three-month" market check during which no buyer for the company emerged (and after which oil prices tumbled, causing significant further financial stress for Bold). After learning that Bold's efforts had not yielded a bidder, Earthstone initiated discussions with EnCap regarding Bold and other EnCap portfolio companies as possible acquisition targets for Earthstone.

After about nine months of discussions among Earthstone, EnCap and Bold about a possible Earthstone-Bold combination, Earthstone formed a special committee to oversee the transaction. The committee

was comprised of two directors, both of whom the court viewed as independent and disinterested. About a month after the committee was formed, Earthstone submitted a formal "offer letter" to Bold. The offer letter expressed (for the first time) that any transaction would be subject to approval by the Earthstone special committee and a majority of the Earthstone stockholders not affiliated with Earthstone management or Oak. In the offer letter, Earthstone proposed that it would own 45 percent of the combined company. Two months of negotiations ensued, with Bold initially counterproposing a 37.5 percent interest for Earthstone, and the parties ultimately agreeing on 38.9 percent. The market reaction was highly favorable, with Earthstone's stock price increasing 27 percent on the day of announcement of the merger agreement (and increasing 67 percent from announcement to closing). The transaction was approved by the special committee and (with 84 percent of Earthstone's outstanding shares voting) by 99.7 percent of the unaffiliated shares voting.

The plaintiff's main contention was that the CEO, to the detriment of the unaffiliated Earthstone stockholders, caused the board and the committee to approve the transaction for the benefit of himself, EnCap and Oak (to save their failing investment in Bold). The plaintiff argued that the transaction should be evaluated under the "entire fairness" standard because the MFW-required conditions were not in place from the outset of the negotiations. Vice Chancellor Joseph Slights ruled that the discussions that preceded the offer letter were "exploratory in nature" rather than "negotiations," and, therefore the ab initio requirement was satisfied. Finding the other MFW requirements satisfied as well, the vice chancellor dismissed the case.

Discussion

MFW and the purpose of the ab initio requirement.

Under MFW, the business judgment rule standard of review applies to a merger with a controlling stockholder so long as, from the outset of the merger negotiations, the controlling stockholder commits to proceed with the merger only if it is subject to both (1) approval by a special committee of independent directors (which is free to select its own advisers, is empowered to "say no" to the transaction, and fulfills its duty of care) and (2) approval by an uncoerced, fully informed vote of a majority of the minority stockholders. If MFW does not apply, or if triable issues of fact remain after discovery as to whether either of the procedural protections was validly established, then, at trial, the more stringent entire fairness standard of review would apply. The court reiterated in Olenik that the purpose of the ab initio requirement is to ensure that the deal structure truly "mimic[s] arms-length dealing, and to neutralize the controller's influence." Using this point in time, the court explained, ensures that the controller cannot, late in the process, to satisfy the special committee, "dangle" before the committee the prospect of imposing a majority-of-the-minority vote condition "rather than having to make a price move" as the "deal-closer."

The court's distinction between "preliminary discussions" and "negotiations" for MFW purposes, while instructive, does not provide concrete guidelines.

The court emphasized the "important distinction" between, on the one hand, preliminary "'discussions' about the possibility of a deal and 'negotiation' of a proposed transaction after the 'discussions' lead to a definitive proposal." In most instances, the court stated, "'negotiations' begin when a proposal is made by one party which, if accepted by the counter-party, would constitute an agreement between the parties regarding the contemplated transaction." The CEO's discussions with EnCap and Bold prior to submission of the offer letter, "while extensive, never rose to the level of bargaining; they were exploratory in nature," the court stated. The court viewed the offer letter as "the first real move in the

negotiating bout." The court noted that the special committee "met several times to formulate its proposal before the Offer Letter was submitted," and that, after the offer letter was delivered, "the special committee and Bold engaged in substantial negotiations before reaching agreement." The two months of negotiations after delivery of the offer letter "included several attacks, parries and remises before a final deal was struck," the court wrote.

The 10-month period of "preliminary discussions" appeared not to include significant price-related discussions between the parties.

Although the court did not address whether price discussions are the critical element in distinguishing preliminary discussions from negotiations, we note that it appears from the court's description of the 10 months of discussions that there were no significant back-and-forth price-related discussions between the parties. Certainly, there was nothing in the record that indicated that the special committee made a tradeoff of inclusion of the conditions in lieu of better pricing. The following activities occurred during the 10-month period leading up to submission of the offer letter:

- Data room access and management presentations by Earthstone and Bold, with reviews by Earthstone of Bold's assets and of technical, operational, financial and analytical information provided by Bold and its banker;

- Meetings by Earthstone with its own bankers to consider valuation parameters related to Bold's assets and the likely equity market receptivity to a deal and meetings with Bold's banker (and sometimes with EnCap) to solicit their views on these topics;

- An update letter from the CEO to the Earthstone board that indicated that Earthstone intended to make an offer for Bold;

- Numerous meetings and calls between Earthstone management and both EnCap and Bold about a potential Earthstone-Bold combination (without further characterization by the court of the content of the discussions);

- A "nonbinding presentation" from Earthstone to EnCap concerning a possible Earthstone-Bold combination based on an equity valuation for Bold of $305 million in Earthstone common stock, and a second presentation with a revised equity valuation for Bold (to reflect additional assets it had acquired) of $335 million;

- Conference calls and meetings among Earthstone, EnCap and EnCap's counsel to develop a timeline, discuss a "suggested action plan," and assign responsibilities for a possible transaction;

- Several meetings between Earthstone management (including the CEO) and Bold management (including Bold's CEO) "to discuss the possible combination" (again, without further characterization by the court of the content of the discussions);

- A revised valuation of Bold by Earthstone (that was not shared with Bold and reflected a value between $300 million and $350 million);

- Nine months after the commencement of discussions between the parties, the formation of a special committee of the Earthstone board, the committee's engagement of advisers, and its holding several committee meetings;

- Valuations by the committee's banker (that were not shared with Bold) (one of which showed a valuation resulting in a 38-39 percent ownership interest for Earthstone, and a later one which supported a 43 percent interest for Earthstone — with the Earthstone board concluding that Earthstone's interest should be "more than 40%" and authorizing the Earthstone CEO to send a proposal to Bold on that basis); and

- Earthstone's submission of the offer letter to Bold (which proposed an ownership interest of 45 percent for Earthstone and conditioned the transaction on approval by both the special committee and a majority of the unaffiliated stockholders).

The two-month period of "substantial negotiations" that followed delivery of the offer letter included meaningful back-and-forth discussions on pricing.

The following occurred after the offer letter was submitted:

- Bold's counterproposal of a 37.5 percent interest for Earthstone;

- The Earthstone special committee's countering with a 40 percent interest for Earthstone;

- Bold's reiterating its 37.5 percent proposal;

- Earthstone's CEO suggesting to the Bold CEO that Earthstone might be able to agree to a 38.5 percent interest;

- The Earthstone committee's banker reiterating that Earthstone should try to negotiate for "at least 40%" and acknowledging that the ownership split "was not the only metric of fairness" and that a number of factors relating to the industry and the characteristics of the two companies made the contribution analysis "less relevant" than in many other contexts;

- Agreement by Earthstone and Bold on the transaction structure (and "Up-C combination");

- Delivery of a fairness opinion by the committee's banker;

- Agreement by Earthstone's CEO and Bold's CEO to seek authority from their respective boards for a deal with a 39 percent interest for Earthstone (and Earthstone CEO's agreement to seek authority to go to 38.7 percent if necessary to reach a final agreement); and, thereafter,

- A 26-minute Earthstone committee meeting at which the committee authorized the CEO to finalize negotiations at a 38.7 percent interest.

The court found that the Earthstone special committee was well-functioning.

First, the court rejected the plaintiff's argument that the two committee directors were not independent. The plaintiff pointed to the facts that (1) EnCap had appointed the two committee directors to their board seats, (2) both the committee directors owned interests in Oak that predated their Earthstone directorships, and (3) one of the committee directors was then CEO of a company which, over three decades, had invested in five different companies led by the Earthstone CEO.

The court stated that (1) appointment to a board seat does not itself indicate nonindependence; (2) the plaintiff had pled nothing about the materiality to the committee directors of their ownership interests in Oak; and (3) the plaintiff had pled nothing about whether the committee director's interests in the CEO's companies would have led him to "feel subject to [the CEO]'s domination (if any)." Second, the court observed that the committee was expressly empowered to hire its own advisers (which it did) and to reject the potential transaction and "walk away." Third, the court found that the committee fulfilled its duty of care, which required that the committee was not "grossly negligent." The court reiterated that "gross negligence is a very tough standard to satisfy," requiring a decision "so grossly off-the-mark as to amount to reckless indifference or a gross abuse of discretion." In this case, the court stated, the committee, over a period of four months, met 16 times; it "actively engaged" with its "indisputably independent legal and financial advisors and considered their advice"; and, following submission of the offer letter, it "engaged in several rounds of negotiations with Bold." Notwithstanding nine months of discussions about the potential combination prior to formation of the committee, the court found that the committee "did not rubber-stamp a fully-baked deal that [the Earthstone CEO] had negotiated." The court noted that the committee actively oversaw the negotiation of terms, including, at the end, "[w]hen a potential final agreement was in sight, [and the Earthstone CEO] was dispatched to broker final terms with [Bold's CEO], and then to bring those terms back to the Special Committee for approval[, which] is precisely what he did."

The court was not troubled by the CEO's conflicts as the lead negotiator for Earthstone.

As discussed, Earthstone's CEO was also a director of the company, having been appointed by Oak. He was also a director of, owned membership units in, and had been the founder and previous CEO of Oak. The court stated: "While [the CEO] did engage directly with Bold and EnCap, it can hardly be viewed as remarkable that a chairman and CEO with [a] proven track record and expertise in the oil and gas industry would have exploratory discussions with a potential merger partner before the formation of the Special Committee and then spearhead negotiations of the merger on behalf of the Special Committee after it was formed." In its discussion of the CEO's role, the court noted its view that the special committee had "diligently monitored the negotiations and actively deliberated the terms of the Transaction with the guidance of its independent advisors early on and throughout the process." Further, in rejecting the plaintiff's contention that the committee had "rubber-stamped" a fully baked deal negotiated by the CEO, the court observed that, before the offer letter was submitted, the special committee had revised Earthstone management's initial equity valuation for Bold (from $335 million to $325 million) and had revised Earthstone's proposed legacy equity ownership (from 38 percent to the 45 percent proposed in the offer letter), and that, after the offer letter was submitted, the committee engaged in two months of back-and-forth negotiations with Bold over the equity split, eventually agreeing to 38.7 percent.

The court rejected the plaintiff's contention that the agreed equity split was not supported by the analysis provided by the banker for the special committee.

Evidence in the record established that the special committee's financial adviser had advised the committee initially that his contribution analysis indicated that the equity ownership for Earthstone stockholders should be 62.4 percent. After further analysis, the adviser's view ultimately was that the Earthstone equity ownership should be "more than 40%." However, the court noted, the adviser also had acknowledged that valuations for the respective companies were affected by the fact that Earthstone was at a more mature stage in its development than Bold, and that the results of a contribution analysis are not as relevant, in the context of this industry, where a mature company is buying acreage from a less mature company. The adviser also advised that using projections that

extended further out would reflect contributions from Bold that were expected to be significant (although using estimates that were further out "could provide less meaningful results").

The court rejected the plaintiff's contention that the stockholder vote was not "fully informed" due to nondisclosure of the financial adviser's "refusal" at one point to provide a fairness opinion.

The court noted that the adviser's reluctance to commit to providing a fairness opinion had occurred months before the final terms of the transaction were agreed upon. The plaintiff had argued that the adviser's reaction was material because it reflected that the adviser was not comfortable with the committee's "push" to influence the adviser to change its initial valuation of the target. The court disagreed and stated that, to the contrary, disclosure would have been required "if [the adviser] had committed to provide a fairness opinion before knowing the final terms of the Transaction."

The court did not decide whether Oak was actually a controller, nor whether, if Oak were not a controller, the case would be dismissed under Corwin.

The court stated that it was not necessary to address these issues given its finding that the prerequisites to application of MFW business judgment review were satisfied and that the case would be dismissed on that basis even if Oak were a controller.

Practice Points

A buyer not imposing the MFW-required conditions during "preliminary discussions" about a potential transaction will not defeat MFW compliance so long as the conditions were imposed when "negotiations" began.

In Olenik, the court reasoned that "negotiations" began following the buyer's submission of a "definitive proposal" (in the form of a formal offer letter). With respect to the court's view of the period preceding submission of the buyer's offer letter as "preliminary discussions," we note that (1) it appears that significant back-and-forth price-related discussions did not occur during this period (although the court did not specifically articulate this as a basis for its finding); (2) meaningful back-and-forth pricing negotiations did occur for two months after submission of the offer letter; (3) there was no indication of a tradeoff between imposition of the MFW approval conditions and pricing; and (4) in the court's view, after the special committee was formed toward the end of the preliminary discussions, the committee functioned well to oversee the process through the signing of the merger agreement.

Earlier, rather than later, imposition of the MFW-required conditions is still the safest course.

In our view, the decision indicates that the court is likely to view a well-functioning special committee and fully informed approval by the minority stockholders as outweighing potential foot faults relating to the ab initio requirement. Nonetheless, a buyer seeking to structure a transaction to be MFW-compliant should consider that the dividing line between "preliminary discussions" and "negotiations" for MFW purposes is still less than certain after Olenik and, therefore, the earliest possible imposition of the required conditions is still the safest course for ensuring MFW compliance.

We note that the critical decision whether to seek to structure a transaction to be MFW-compliant typically relates to the minority stockholder vote condition rather than the ab initio or other requirements.

A controller may decide to forego the business judgment rule protections available for an MFW-compliant transaction because the controller does not want to subject the transaction to the uncertainty of a vote by the unaffiliated stockholders.

If the board or special committee selects as the lead negotiator a person who has actual or potential conflicts of interest with respect to a transaction, the board or committee should:

- Obtain all relevant information about the conflicts and carefully consider (a) to what extent the conflicts indicate that the person's interests are not aligned with the other stockholders with respect to the transaction, and (b) whether the reasons for relying on this particular person outweigh the concerns arising from the conflicts; and

- Take actions to seek to manage the conflicts, including ensuring that the special committee actively and effectively oversees the process. Other actions could include establishing parameters for the person's role (such as limiting his or her role so that it does not include, say, price negotiations, or having a special committee member join the person in all discussions or discussions relating to specific topics).

Gail Weinstein is senior counsel at Fried Frank Harris Shriver & Jacobson LLP.

Robert C. Schwenkel, Steven Epstein and Brian T. Mangino are partners at the firm.

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