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Delaware Supreme Court Overturns the Court of Chancery's Finding that a Controller-Led Transaction Was MFW*-Compliant "From the Outset" of Negotiations*—Olenik

In the Delaware Court of Chancery's July 2018 decision in *Olenik v. Lodzinski*, the court found that the controller-led merger being challenged was compliant with *MFW*. The Court of Chancery therefore applied business judgment review and dismissed the case at the pleading stage. On appeal, the Delaware Supreme Court has now found (Apr. 5, 2019) that *MFW*'s *ab initio* requirement was not satisfied and therefore ruled that *MFW* was not applicable. The Supreme Court has remanded the case to the Court of Chancery for review under the more stringent "entire fairness" standard (which applies to conflicted controller transactions when *MFW* is not applicable).

Under the Delaware Supreme Court's 2014 *MFW* decision (*Kahn v. M&F Worldwide Corp.*), a conflicted controller transaction will be reviewed under the business judgment standard if the transaction is irrevocably conditioned on approval by both an independent special committee and a majority of the minority stockholders. The Supreme Court mandated in *MFW* that these conditions be imposed "from the outset" of negotiations (the so-called "*ab initio* requirement"). In *Olenik*, the Court of Chancery found that, although the parties engaged in ten months of discussions before the *MFW* conditions were imposed by the buyer (when it sent its formal offer letter), the *ab initio* requirement was satisfied because the discussions, while "extensive," were only "exploratory" and "preliminary" and therefore did not constitute negotiations. The Supreme Court disagreed, finding that the plaintiff pled facts supporting a reasonable inference that, before the conditions were imposed, the parties' discussions had "transitioned" to being "substantive economic discussions."

Key Points

- **The Delaware Supreme Court decision in *Olenik* undercuts the suggestion, which arose from the Court of Chancery decision, that there may be considerable leeway for controllers in the extent to which discussions may occur between the parties before a determination is made whether or not to structure a transaction to be *MFW*-compliant.** Importantly, the Supreme Court clarified that, for *MFW* to be applicable, the *MFW*-required conditions must be imposed "early in the process." The Supreme Court suggested that the appropriate time to impose the conditions is during "the germination stage of the Special Committee process," which is "when advisors [are] being selected" and "due diligence [is] beginning" and "before there has been any economic horse trading."

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- **The Supreme Court stated that the *Olenik* parties' communications "transitioned" from being "preliminary discussions" to being "substantive economic negotiations" when the parties "engaged jointly in exercises to value [the target company]," which "set the parameters for the economic negotiations to come."** Although the parties' discussions did not include actual price negotiations, the valuation discussions "fixed the field of play for the eventual transaction price"--and, indeed, the ultimate pricing *was* within that playing field. Thus, we observe, in this case, the discussions that occurred before imposition of the *MFW* conditions provided a template for the ultimate transaction.

- **The decision highlights the importance of good process and adequate disclosure.** First, for *MFW* to be applicable, the court must view the special committee as having been "fully authorized" and having "functioned effectively" and the stockholder vote as having been "fully informed" and "uncoerced." Further, if *MFW* is deemed *not* applicable, the transaction will be subject to review under the "entire fairness" standard, which requires that both the price and the process were fair to the minority stockholders. Notably, given the Court of Chancery's finding in *Olenik* that the special committee was independent and, as affirmed by the Supreme Court, that the disclosure was adequate, on remand the transaction may well pass muster under entire fairness.

Background

Earthstone Energy, Inc. acquired Bold Energy LLC, pursuant to an all-stock merger, with the Earthstone and Bold legacy stockholders ending up owning about 39% and 61%, respectively, of the combined company. Bold (which was financially troubled) was owned 96% by its controller (EnCap Investments, L.P., a private equity firm); and EnCap also owned 41% of Earthstone (through EnCap's controlling interest in holding company Oak Valley Resources, LLC). This situation resulted in an incentive for the controller (EnCap) to favor a better deal for the target (Bold) as compared to the acquiring company (Earthstone)--and, therefore, a need for protections for the minority stockholders of the acquiror (rather than, as would be the usual case, the target).

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. "L," who was the CEO and a director of Earthstone, served as Earthstone's lead negotiator throughout the process--although he had a financial interest in Oak and other connections with EnCap.

Preceding the merger discussions, Earthstone had pursued a year-long "acquisition spree" that created significant value for the company; EnCap was reaching the end of a 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 nine months of discussions among Earthstone, EnCap and Bold about a possible Earthstone-Bold combination, Earthstone formed a special committee (the "Committee") to oversee any transaction. The Committee was comprised of two purportedly independent and disinterested directors. About a month after the Committee was formed, Earthstone submitted a formal "offer letter" to Bold (the "Offer Letter"), which expressed (for the first time) that any transaction would be subject to approval by the Committee and by a majority of the Earthstone stockholders not affiliated with Earthstone management or Oak.

In the Offer Letter, Earthstone proposed that it would own 45% of the combined company. Two months of negotiations ensued, with Bold initially counter-proposing a 37.5% interest for Earthstone, and the parties ultimately agreeing on 38.9%. The market reaction was highly favorable, with Earthstone's stock price increasing 27% on the day of announcement of the merger agreement (and increasing 67% from announcement to closing of the merger). The transaction was approved by the Committee and by 99.7% of the unaffiliated Earthstone shares voting (with 84% of the outstanding shares voting).

The plaintiff brought suit in the Court of Chancery, contending that L, 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 Slights ruled that the discussions that preceded the Offer Letter were "exploratory in nature" rather than "negotiations," and, therefore that the *ab initio* requirement was satisfied. Finding the other *MFW* requirements satisfied as well, the Vice Chancellor dismissed the case. The defendants appealed. The Delaware Supreme Court found that the plaintiff had pled facts that supported a reasonable inference that the discussions that preceded the Offer Letter included "substantive economic discussion." Therefore, the Supreme Court ruled, *MFW*'s *ab initio* requirement was not satisfied and *MFW* did not apply. The case was remanded for further proceedings with the transaction to be reviewed under the entire fairness standard.

Discussion

The *MFW "ab initio"* requirement. The premise of the *ab initio* requirement is that if, *before negotiations commence*, a transaction is subjected to the irrevocable conditions of approval by an independent special committee and a majority of the minority stockholders, the transaction takes on the characteristics of a third-party arm's-length merger. In other words, the controller-acquiror will have "disabled itself from using its control to dictate the outcome of both the negotiations and the stockholder vote" and the parties will "bargain under the pressures exerted on both of them by these protections."

***Olenik* clarifies the difference between "preliminary discussions" and "negotiations" for purposes of the *ab initio* requirement--although there is still no bright-line test.** The Court of Chancery held that, notwithstanding ten months of discussions, for *MFW* purposes, the "negotiations" did not begin until Earthstone submitted a "definitive proposal" (in the form of the formal Offer Letter, which contained the *MFW*-required conditions). 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 definitive proposal had been made. Importantly, the factual context in *Olenik* included (i) no evidence of significant price discussions having occurred during the months of discussions preceding the Offer Letter; (ii) two months of back-and-forth negotiation over pricing (*i.e.*, the equity split) *following* submission of the Offer Letter; (iii) a Committee that the court viewed as having been independent and having functioned effectively; and (iv) no evidence that the initial discussions involved a tradeoff where the controller agreed to accept the *MFW* approval conditions in exchange for a lower price.

In overturning the Court of Chancery's ruling, the Supreme Court cited its *Flood v. Synutra* decision (2018) (which was decided just after the Court of Chancery decision in *Olenik*). In *Synutra*, the Supreme Court found that the *ab initio* requirement was satisfied in that case based on the controller having conditioned its offer on the *MFW* protections "at the germination stage of the Special Committee process, when [the Committee] was selecting its advisors, established its method of proceeding, began its due diligence, and had not commenced substantive negotiations with the controller." In *Synutra*, the Supreme

Court described the ordinary meaning of "from the beginning" as "the first stage of an ongoing process," and stated that "*MFW* is not satisfied if a controller has not accepted that no transaction goes forward without special committee and disinterested stockholder approval early in the process and before there has been any economic horse trading."

The Supreme Court stated that the "preliminary discussions" had "transitioned to substantive economic negotiations" when "the parties engaged in a joint exercise to value Earthstone and Bold." The defendants argued that the discussions between the parties prior to the delivery of the Offer Letter and establishment of the Committee did not equate to negotiation or "horse trading" because "neither side changed its position on any issue" before the Offer Letter. However, the Supreme Court stated that it is reasonable to infer that the parties' $305 million valuation of Bold, which was then raised to $335 million, "set the field of play for economic negotiations to come by fixing the range in which offers and counteroffers might be made." Moreover, the Supreme Court noted that, according to the facts pled, "that generally turned out to be the case"--as the Offer reflected an equity valuation for Bold of $300 million and the final deal reflected an equity valuation of $333 million.

Additional factors cited by the Supreme Court as supporting that the discussions constituted negotiations were that, in April 2016, L told the Earthstone board that he was "updating his analysis" of Bold and intended to make an offer; in an August 2016 letter to the Earthstone board, L said he was "negotiating" with Bold while the committee advisors were "still getting up to speed"; and, in presentation materials used at an August 10, 2016 board meeting, Earthstone management presented the transaction with an "already presumed timeline" (with announcement planned for the third or fourth quarter of that year) and an "assumed" price of $333 million.

The determination whether discussions were "preliminary" or involved "substantive economic negotiation" will be highly fact-specific. In *Olenik*, while the Supreme Court emphasized the joint valuation exercise that "set the playing field" for the price negotiations, the court pointed to the following events as, taken together, indicating that "preliminary discussions [had] transitioned to substantive economic negotiations" well before the August 19, 2016 delivery of the Offer Letter that contained the *MFW* conditions:

- In November 2015, EnCap provided Earthstone with a presentation that its investment bank (TPH) had used the previous summer to market Bold; Earthstone management and EnCap held a conference call to discuss a potential deal for Bold; and Earthstone and EnCap executed a confidentiality agreement.
- In December 2015, EnCap provided information to Earthstone about Bold (including access to a data room and confidential technical, operational, financial, and analytic information about Bold); Earthstone entered into a confidentiality agreement with Bold; Earthstone management spoke with TPH; TPH provided a technical overview of Bold's assets to Earthstone and EnCap; and Earthstone, EnCap and TPH met again to discuss Bold's assets.
- Also in December 2015, Earthstone management met with three separate investment banks to obtain their views on valuation parameters for Bold's assets, methods for funding their development, and equity market receptivity to a possible deal with Bold.
- At a May 3, 2016 Earthstone board meeting, there were presentation materials that indicated an "Active" potential deal with Bold as the "Seller" and EnCap as a "Financial Partner."

- In May 2016, "there were multiple substantive economic communications between Earthstone and EnCap"--specifically, (a) Earthstone management delivered a presentation to EnCap about the proposed deal indicating an equity valuation for Bold of about $305 million, which EnCap said it would review with TPH; (b) a week later, Earthstone management, at another presentation to EnCap about the proposed deal, raised the valuation to about $335 million; and (c) several days after that, Earthstone communicated again with EnCap and TPH about the proposed deal and gave TPH access to Earthstone's data room (which included Earthstone's combined corporate model of the two companies and a model of Earthstone's net asset valuation).
- In June and July 2016, there were "numerous meetings" between various representatives of Earthstone, EnCap, Bold and TPH, "including meaningful on-site due diligence regarding Bold's assets in West Texas."

The decision highlights the importance of a good process and adequate disclosure. As noted, on remand, the transaction will be subject to review under the entire fairness standard, which requires that both the price and the process were fair to the minority stockholders. Importantly, the Court of Chancery's description of the background facts included numerous positive factors relating to price and process, indicating that the transaction may well pass muster under entire fairness. For example, (i) the target's minority stockholders approved the transaction overwhelmingly; (ii) the target's stock price soared between announcement of the deal and the closing; (iii) the Court of Chancery viewed the Committee as having been comprised of independent members and having functioned effectively in overseeing the process and as not having "rubber-stamp[ed] a fully-baked deal"; and (iv) the Court of Chancery viewed the disclosure as adequate (with this finding also affirmed by the Supreme Court).

The Supreme Court also ruled that EnCap did not cease to be a controller prior to the beginning of negotiations. The Court of Chancery had not addressed whether Oak was actually a controller (nor whether, if Oak were *not* a controller, the case would have been dismissible under *Corwin*). The Court of Chancery stated that it was not necessary for it 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. On appeal, the defendants asked the Supreme Court to affirm the Court of Chancery's dismissal of the case on this alternate ground that compliance with *MFW* was not necessary for application of business judgment review because EnCap had "shed its controller status" before the Offer Letter was delivered. Specifically, until mid-June 2016, EnCap owned a majority of Oak's units, and Oak in turn owned a majority of Earthstone stock; but, after a reverse merger involving Earthstone and Oak in 2016, Oak's ownership interest in Earthstone dropped below majority ownership (about 41%).

The Supreme Court agreed with the defendants that, for a stockholder to be a controller, it must (a) own a majority of the corporation's voting power or (b) have and exercise "effective control" over the corporation's conduct. While Oak's ownership in Earthstone dropped to below 50% in mid-June 2016, the Supreme Court found that the plaintiff had pled facts that supported a reasonable inference that EnCap (a) controlled Earthstone after the 2016 reverse merger and (b) also held a majority of Earthstone's stock "while substantive economic negotiations took place that fixed the field of play for the eventual transaction price." These facts were that (i) in Earthstone's Form 10-K issued after the Offer Letter, Earthstone described itself as "a company with a controlling shareholder"; (ii) EnCap, through L, led the negotiations for the transaction; and (iii) L negotiated his continued employment with Earthstone before Earthstone formally created the special committee. Moreover, the Supreme Court stated, "key substantive economic negotiations" occurred before the Offer Letter, "when it is undisputed that EnCap controlled Oak Valley

and Earthstone"; the two valuations of Bold that the parties arrived at (which were proposed by L) occurred in May 2016; and "there were multiple other meetings, confidentiality agreements, due diligence, and logistical discussions while Encap was a majority stockholder." Thus, the Supreme Court concluded, the defendants were not entitled to a dismissal at the pleading stage because "the facts pled support the reasonable inference that EnCap acted as Earthstone's controlling stockholder while key economic negotiations took place between Earthstone and Bold which set the financial playing field for later negotiations."

The Supreme Court also affirmed the Court of Chancery's ruling that the disclosure was adequate. On appeal, the plaintiff claimed that the proxy disclosure was deficient in not disclosing that (i) the initial contribution analysis by the Committee's financial advisor did not support a 40/60 Earthstone/Bold split for the transaction; (ii) the advisor was pressured to revise its analysis, which helped support the final split; and (iii) EnCap was motivated to sell Bold due to its cash position.

As to (i) above, evidence in the record established that the special committee's financial advisor had advised the committee initially that his contribution analysis indicated that the equity ownership for Earthstone stockholders should be 62.4%. After further analysis, the advisor's view ultimately was that the Earthstone equity ownership should be "more than 40%." However, the court noted, the advisor 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 advisor 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 Supreme Court noted as follows: although the proxy did not discuss the changes in the advisor's analysis, it did include projections for each of the years 2017-2019; the advisor had emphasized that it did not regard the relative contribution metrics as "meaningful" given the difference in "development stages" of the two companies; and, from the yearly projections, it was apparent that the contribution analysis favored Earthstone in the early years and Bold in the later years. Thus, the Supreme Court concluded, "Investors were free to place the emphasis where warranted." As to (ii) above, the Supreme Court stated that the defendants "do not have to adopt plaintiffs' characterization of the facts." As to (iii) above, the Supreme Court stated that "the reason was apparent on the face of the proxy" (as it disclosed Bold's financials and they showed that Bold was in a poor cash position), and the board "was not obligated to characterize Bold's cash position, particularly when the facts were disclosed and neither the Special Committee nor the Board actually concluded that Bold was distressed and needed to sell."

Practice Points

- **A controller should carefully consider whether to structure a transaction to be *MFW*-compliant after weighing the advantages and disadvantages.** The key advantage is that, if the transaction is challenged, it would be evaluated under the business judgment standard, with dismissal likely at the early pleading stage of the litigation. The key disadvantages may include uncertainty arising from subjecting the transaction to approval by the minority stockholders; the risk that the deal terms will be less favorable to the controller than they otherwise would have been; and/or the possibility of triggering shareholder activism or share accumulations by arbitrageurs, which (among other possible consequences) could create another focal point for negotiation of the transaction.

- **The earlier in the process that the *MFW*-required conditions are imposed, the less risk that the transaction will be viewed as non-compliant with *MFW***. Even after *Olenik*, there is not a definitive dividing line between "preliminary discussions" and "negotiations" for *MFW* purposes. Therefore, the earliest possible imposition of the required conditions is the safest course for ensuring *MFW* compliance. The key factor will be whether the conditions were imposed before there were price negotiations or "economic horse trading." *Olenik* and *Synutra* suggest that the *MFW* conditions should be imposed "at the germination stage of the Special Committee process, when it was selecting its advisors, established its method of proceeding, began its due diligence, and had not commenced substantive negotiations with the controller."

- **Companies should carefully choose the words they use to describe facts or events, with a view to their possible future use as evidence.** For example, in *Olenik*, the court viewed the proxy disclosure that the controller was "negotiating" the transaction as evidence that the controller was at that time engaged in "negotiations" rather than "preliminary discussions"; viewed the board presentation materials that characterized the proposed transaction as "Active" as additional evidence that "negotiations" were underway; and viewed the company's 10-K disclosure that the company was "controlled" as evidence that the purported controller was in fact a controller.

- **We note that the Court of Chancery did not find it problematic for the process that the lead negotiator for the buyer had significant ties to the controller.** The Court of Chancery 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. The issue of the lead negotiator's conflicts was not addressed in the appeal to the Supreme Court.

- **Good process and disclosure are important.** In *Olenik*, as discussed, even though *MFW* will not apply because the *ab initio* requirement was not satisfied, the transaction may well pass muster under entire fairness given that the court found that the special committee was independent and functioned effectively and that the disclosure was adequate. Also, notably, it is not always clear-cut whether a party is a controller and, in *Olenik*, if the court had found that EnCap was *not* a controller, then *Corwin* presumably would have applied (and the case dismissed at the pleading stage on that basis) given that the court found that the disclosure was adequate.

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