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Court of Chancery Applies the MFW *"*Ab Initio*" Requirement to a Special Committee in a Non-MFW Case*–Salladay

In *Salladay v. Lev* (Feb. 25, 2020), the Delaware Court of Chancery held, at the pleading stage, that the merger (the "Merger") of InterSections, Inc. (the "Company") with an acquisition vehicle formed by the iSubscribed Investor Group would be subject to "entire fairness" review even though it had been approved by both a special committee (the "Committee") and the stockholders. The court ruled that (i) the Committee, although comprised of independent, unconflicted directors, was not formed early enough in the process to counteract the influence of the "interested" directors; and (ii) the disclosure was insufficient, thus the approval by a majority of the stockholders not affiliated with the interested directors did not "cleanse" the transaction under *Corwin*.

Key Points

- **The decision is notable for expressly holding that *MFW*'s "*ab initio*" requirement also applies in a non-*MFW* context (*i.e.*, when the transaction does *not* involve a controlling stockholder) if at least half the board is conflicted**. *MFW* provides for business judgment, rather than entire fairness, review of a challenged transaction involving a conflicted controller if, *ab initio* (*i.e.*, "from the outset"), the transaction was conditioned on approval by an independent special committee and the minority stockholders. Under *MFW* jurisprudence, to satisfy the *ab initio* requirement, the committee must be established before the parties engage in "substantive economic negotiations." In a non-*MFW* context, the usual test for the efficacy of an independent special committee is whether it was "fully empowered" and "functioned effectively"–an inquiry that is highly dependent on the specific facts and circumstances relating to the committee's process and result. In *Salladay*, however, the court focused on the timing of the Committee's formation. The court reasoned that, even without a controller, if half the board is conflicted, a committee could not be "fully empowered" if it were formed after the parties engaged in "substantive economic negotiations"–because it would have "entered the negotiations after the point at which it could act to replicate an arm's-length transaction."

- **The decision amplifies the parameters (under *MFW*'s "*ab initio*" requirement) as to *when* "substantive economic discussions" begin**. The Committee was formed about three weeks after the acquiror first approached the Company. The court emphasized that, prior to the Committee's formation, one of the "interested" company directors suggested to the acquiror a range of values that the board would find acceptable. The court concluded that this "set the stage" for the pricing negotiations that followed--as evidenced by the acquiror making its initial bid at the "precise bottom" of that range and ultimately increasing its offer to just below the mid-point.

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- **The decision underscores that the reasons for financial advisor "exits" may be material information that should be disclosed to stockholders**. The court found the Company's Schedule 14D-9 disclosure was misleading because, among other issues, it did not explain why a series of three financial advisors had been engaged by the Committee.

Background. The Company's Board was comprised of six directors. Three were independent and unconflicted with respect to the Merger. The other three were: "L"–who was affiliated with the private equity firm that co-founded the Company and held a 42.7% equity stake; "S"–the Chairman, CEO, and co-founder, who owned an 8.7% equity stake; and "M"–who had longstanding commercial relationships with the Company and owned a 4.7% equity stake. Although the plaintiff did not assert that the Company was controlled, the Company's SEC filings stated that L, S and M collectively owned "a stake that was potentially controlling."

In 2017, while the Company worked on a critical upgrade to its only product, it was experiencing financial difficulties and increased its credit agreement borrowings. In early 2018, it looked for other opportunities to raise capital and several parties expressed interest. The Board formed the Committee (comprised of the three independent, disinterested directors) to evaluate potential financing transactions. The Committee retained "Banker A" and considered a number of potential financing transactions, but none was finalized. Eventually, the effort and the Committee were "abandoned." The Company issued promissory notes to L's private equity firm and to M, in return for $2 million and $1 million, respectively, to help pay down its borrowings. On September 14, 2018, the iSubscribed Investor Group contacted the Company to explore a possible financing transaction. L, S and the Company's CFO met with iSubscribed; and, within a week, iSubscribed signed a confidentiality agreement and commenced due diligence.

On September 24, iSubscibed expressed interest in acquiring the Company instead and it formed an acquisition vehicle ("WC"). On September 27, WC met with S, who "effectively told [WC] that the Intersections Board would be receptive to an acquisition offer of $3.50 to $4.00 per share." On October 5, the Board reconvened the Committee and determined that it would not approve a transaction unless it was recommended by the Committee. L, S and M all expressed a desire to roll over the substantial majority of their equity in a going-private transaction with WC. On October 9, WC proposed to acquire the Company for $3.50 per share and provide $30 million of senior secured convertible note financing. The acquisition contemplated a rollover of L, S and M's equity; and an exchange into convertible notes, at a favorable rate, of the promissory notes held by L and M. On October 10, the Committee met, engaged legal counsel, and determined that any acquisition would be conditioned on approval by a majority-of-minority stockholders. On October 11, WC raised its offer to $3.68 per share and the Committee engaged "Banker B." On the Committee's recommendation, the Board enter into an exclusivity agreement with WC. A few days after Banker B was retained, it resigned. The Committee then engaged "Banker C," which provided a fairness opinion eight days later.

The exclusivity agreement permitted the Company to continue already existing discussions with potential financing partners. While negotiations with WC were ongoing, two of these potential partners submitted proposals offering financing in a mix of debt, convertible notes, and equity. Over the course of two weeks, while working on the WC transaction, the Committee had one phone call with each of these parties and did not make any counter-proposals or engage in negotiations. The Committee recommended, and the Board approved, the transaction with WC. On October 31, the Merger Agreement and a Note Financing Agreement were executed and S, L and M entered into support agreements. The Plaintiff filed suit against S, L and M. Vice Chancellor Glasscock, at the pleading stage, denied the defendants' motions to dismiss.

Discussion

The court reviewed the applicability of the business judgment and entire fairness standards. Under Delaware law, when an independent and disinterested board acts, the court reviews its actions under the deferential business judgment standard of review. However, when "at least half of the directors who approved [a] transaction were not independent or disinterested," then "[the court's] scrutiny increases, and the transaction may be subject to entire fairness review." Entire fairness also applies when there is a controlling stockholder that is conflicted in the transaction. When entire fairness applies, "a company can implement procedural safeguards that cleanse the transaction, and regain business judgment review." When there is a conflicted controller involved, a board "can recover business judgment review," under *MFW*, "by making the transaction contingent from inception upon the presence of a fully constituted, fully authorized special committee *and* a vote of informed and uncoerced minority stockholders." When there is *not* a conflicted controller, then, (a) obtaining "approval by a fully-informed, uncoerced vote of disinterested stockholders" can "cleanse" a transaction, under *Corwin*; or (b) approval by "a fully-empowered, independent special committee can potentially cleanse the transaction under the rationale noted in *In re Trados Inc*. *Shareholder Litigation* (*Trados II*)."

The court found that "at least half" of the board was "interested" in the Merger. Most significantly, three of the six directors rolled over "substantial portions" of their equity in the Merger–L, 80% of his stake; M, 69%; and S, 36%. In addition, S received a change-in-control payment of about $5.85 million and an 18-month consulting agreement with WC worth $500,000 in cash as well as a stock option grant to acquire over 839,000 shares of WC common stock. Under the Note Purchase Agreement, notes (which were convertible into common stock at a price of $2.27 per share) were issued to S and M, respectively, in the amounts of $3 million and $1 million. The court determined that L, S and M "stood on both sides of the Merger as co-purchasers with [WC]," and thus entire fairness applied "unless [the transaction] was properly cleansed through procedural safeguards." As there was no allegation that the Merger was subject to a controlling stockholder or control group, "cleansing under *Corwin* or *Trados II* [was] possible." However, the court found the disclosure materially misleading and the procedural protections lacking (as discussed below), and thus ruled that the Merger remained subject to entire fairness review.

The court stated that the "*ab initio*" requirement with respect to formation of a special committee applies even in a non-*MFW* case. The court stated that "the true empowerment of a committee of independent, unconflicted directors removes the malign influence of the self-interested directors, and thus should result in business judgment review." Whether a committee is "truly empowered" depends in part on "the timing of the formation of the committee." Therefore, the "*ab initio*" requirement applicable in the *MFW* context when there is a controller–*i.e.*, that, "*from the outset*," the transaction is conditioned on approval by an independent special committee–applies also "in the context of a majority-conflicted board" (without the presence of a controller). What is important, the court wrote, is that "[t]he acquirer–as well as any interested directors–must know from the transaction's inception that they cannot bypass the special committee." Thus, "[e]ven in a non-control setting, commencing negotiations prior to the special committee's constitution may begin to shape the transaction in a way that even a fully-empowered committee will later struggle to overcome. In that scenario,…the existence of the committee is insufficient to replicate an arm's-length transaction."

The court found that the Committee was formed *after* "substantive economic negotiations" took place. During the three weeks between the acquiror's first contacting the Company and the Committee being established: (i) S and L met once with WC to provide an overview of the company, outline in broad terms how an acquisition might be approached, and gain an understanding of the WC's intentions; (ii) WC

entered into a confidentiality agreement and commenced due diligence; (iii) WC's banker made a call to L to discuss the potential acquisition; (iv) WC met once with S, during which meeting S "effectively related that the Board would be receptive to an offer of $3.50 to $4.00 per share" (although the Company's 14D-9 stated that S had only expressed his personal view and had emphasized that he did not have authority to negotiate on the Company's behalf); and (v) the parties engaged in a week of "discussions."

The court acknowledged that, in *Olenik* (2018), where, in an *MFW* case, it found that the *ab initio* requirement was not satisfied, "the parties' involvement, pre-committee, was more extensive than here." In *Olenik*, the parties engaged in "several months" of discussions and due diligence, including "a joint valuation process to fix the range of values for the company." In this case, the parties had engaged for only three weeks and S told the acquiror "to base an offer on the 'independent value' rather than the trading price and gave a range he thought would engage the Board." However, the court concluded that, as in *Olenik*, the pre-Committee discussions in this case "set the stage for future economic negotiations." This inference was strengthened, the court stated, by the fact that WC "came in at $3.50, the exact lower end of S's suggestion, and raised its offer, once, to $3.68, just under the middle of the range he provided." Making all inferences in favor of the plaintiff, as it was required to do at the pleading stage, the court found it "conceivable that these discussions prior to the Committee's reconstitution essentially formed a price collar that set the field of play for the economic negotiations to come…and deprived the Committee of the full negotiating power sufficient to invoke the business judgment rule." Further, the court commented in a footnote that, in *Olenik*, the court "note[d] the well-known phenomenon of 'anchoring,' by which a target company's providing a starting value biases future adjustments toward that initial value."

The court found that the transaction was not cleansed under *Corwin* because the disclosure was materially inadequate. Under *Corwin*, in the absence of a controlling stockholder, business judgment review will apply if a transaction was approved by the stockholders in a "fully-informed" and "uncoerced" vote. In such a case, "the informed and empowered corporate electorate has accepted the transaction in light of, and in spite of, any conflicts of interest or other fiduciary defects, and this Court will not second-guess such an informed vote by the corporate owners." The defendants contended that the 14D-9 disclosed all material facts "and thus the well-informed stockholders had their choice between alternatives–on the one hand, a 112% premium over trading price; on the other hand, maintaining an equity stake in a company about to launch a historic flagship product." The plaintiff argued, however, that the 14D-9 was misleading in (i) "suggest[ing] to the stockholders that if they did not approve the Merger, control would transfer to [WC]" in any event; and (ii) omitting other "material information regarding the Transaction and advisors."

The court found that the disclosure was misleading regarding a transfer of control to WC if the Merger were not approved. The 14D-9 disclosed that, under the Note Purchase Agreement, if the Merger Agreement were terminated (other than by reason of a breach by WC), WC had a contractual right to appoint a majority of the Board and the CEO. It also disclosed that the Board, when determining to approve the Merger, had considered that WC had this right. The 14D-9 also disclosed that the right was subject to NASDAQ listing rules; and the 14D-9 set forth the full text of the applicable rule. However, the court ruled, the 14D-9 did not state "simply" that, under the NASDAQ rule, WC could not exercise this right unless, at the time of exercise, it held a majority of the outstanding shares. Moreover, the 14D-9 did not "outright" state WC's ownership percentage (which was about 33%). Instead, a stockholder would have to piece together information from different places and then make a mathematical calculation (including with respect to the total number of shares into which the Company's outstanding notes would be convertible) to determine WC's ownership interest. The 14D-9 thus "[left] the stockholder on her own

to look past the impression of a contractual right to control that the 14D-9 creates, and to discern that the application of [the NASDAQ Rule] might supersede this outcome. Then, without guidance from the 14D-9, the stockholder must track down stock ownership numbers in the exhibits to complete the analysis." Given the "fundamental" nature of the issue of the change of control, it was "plausible" that the disclosure was "ambiguous, incomplete or misleading" and/or was "coercive" (because "it suggest[ed] on its face a sell-or-change-of-control choice").

The court found that the disclosure was misleading regarding the engagement (and exits) of the Committee's financial advisors. According to the Complaint, the Committee had hired Banker A to consider potential financial transactions for the Company and, when the Committee was revived to consider the Merger, Banker A was "not reengaged." The Committee then engaged Banker B (whose identity it did not disclose other than to say that it was a "nationally recognized" financial adviser) a*fter* the Company had already "received [WC]'s final proposal for the transaction"–that is, the court stated, "the new financial advisor…walked into a nearly fully formed transaction and merely needed to approve it." As alleged, a few days later, "the new financial advisor mysteriously terminated the engagement"; then, "after a two-day search, the Company hired [Banker C], which provided a fairness opinion eight days later." The defendants argued that disclosure on the topic of engagement with the advisors was immaterial given the extensive disclosure that was provided about Banker C's fairness opinion. The court disagreed. The court wrote: "[Banker A] was informed about the Company's circumstances but for undisclosed reasons was not retained." Then, "[Banker B] accepted the Committee's engagement…[and] "presumably,…reviewed the Transaction in preparation to provide an opinion[, but] *[i]t then walked away*." The court acknowledged that Banker B may have exited for "innocent" reasons (such as a conflict or timing issues); alternatively, though, the exit may have been because "it could not approve the transaction." Either way, the court stated, in evaluating the transaction, the Board and Banker C "would themselves [have] want[ed] to know why a well-known financial advisor voluntarily terminated an engagement and walked away from a fully formed transaction. It follows that so would a reasonable stockholder." The court stated that the "compressed timing of this transaction and the fairness opinion associated with it…create[d] a context in which information regarding a hired financial advisor that walk[ed] away becomes plausibly material."

Practice Points

- ***Special committees***. If a special committee is to be utilized, it would be prudent for it to be established and functioning as early in the process as possible to reduce the risk of it being deemed to have been formed *after* the company engaged in "substantive economic negotiations" with respect to the transaction. Directors should be aware that, if a special committee is to be utilized, none of them should engage in *any* discussion with a prospective buyer or its advisors regarding value or price before the committee is established and functioning, and no substantive discussions with the buyer should occur without the buyer understanding that any transaction is subject to the approval of the committee. While not an issue in *Salladay*, a board also should seek to ensure that a majority of the members of a special committee are independent and not "interested" in the transaction–a determination that is highly dependent on the specific facts and circumstances, which can change and so must be re-evaluated over time (as elucidated in the court's recent decisions in *AmTrust* (Feb. 28, 2020), *Voigt v*. *Metcalf* (Feb. 10, 2020), *McElrath v*. *Kalanick* (Jan. 13, 2020), and *BGC Partners* (Sept. 30, 2019)).

- ***Potential to overcome "late" establishment of a special committee***. If a committee was not established upfront and a decision is later made to utilize a committee, the board should (i) establish the committee as quickly as possible, (ii) clearly communicate to the acquiror and all interested

directors that the board has determined not to approve a transaction unless it is recommended by the committee, (iii) seek to ensure that there is a sufficient time period following formation of the committee for it to be effective, and (iv) document the work of the committee. Notably, in *Salladay*, it was only the day before the acquiror's final price was received that the board determined it would not approve a transaction unless it was recommended by the Committee–and the opinion does not indicate whether that determination was communicated to WC. Also, the overall factual context involved (i) a transaction that the court found conceivably was unfair as to both price and process and (ii) a company that (although no party alleged it was controlled) had stated in its SEC filings that it was "potentially controlled" by three of its six directors–both of which may well have helped influence the court to apply the *MFW ab initio* requirement.

- ***Disclosure; banker resignations***. The decision serves as another reminder that, in general, erring on the side of clear and full disclosure is the preferable course in light of the potential for cleansing of any fiduciary breaches if *Corwin* is applicable. In *Salladay*, clear and full disclosure about the effect of the NASDAQ Rule, for example, would have provided a far greater benefit to the Company and its directors (*i.e.*, potential *Corwin* applicability) than the disclosure that was made instead which may have had the "benefit" of influencing stockholders to vote for the Merger. In addition, companies should consider the appropriate disclosure (if any) in the event that a banker resigns, refuses to accept an engagement, is not "reengaged" after a recent engagement, or fails to provide a requested fairness opinion. In general, companies should keep in mind the following guidepost the court offered in *Salladay* (citing the Delaware Supreme Court's holding in *Appel* (2018)): "In making disclosures, a company ought to put itself in the shoes of what its own decision-makers would want to know." In other words, "stockholders should not be expected to speculate about facts any reasonable board advisor or director would find to be of importance."

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