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Delaware Court Clarifies When *MFW*'s Protections Must be in Place Under "*Ab Initio*" Requirement

The recent Delaware Court of Chancery opinion in *Olenik* v. *Lodzinski* held that the parties to an acquisition had met the now well-known roadmap for controller transactions to receive business judgment review under *Kahn* v. *M&F Worldwide Corp*. ("*MFW*") and dismissed plaintiff's claims as a result. In so holding, Vice Chancellor Slights provides some helpful reminders about how best to achieve *MFW*'s protection, including that the "*ab initio*" requirement mandates that the controller condition the transaction on the special committee and majority-of-the-minority protections at the outset of negotiations, which may occur after "exploratory" discussions between the parties.

Background

Beginning in late 2015, the management of Earthstone Energy, Inc. ("Earthstone") and Bold Energy III LLC ("Bold") began discussing a possible transaction. At the time, EnCap Investments, L.P. ("EnCap") was the indirect beneficial owner of 41% of Earthstone common stock and also owner of 96% of Bold. After a few months of communications between management about a possible deal and terms, Earthstone formed a special committee of independent directors to oversee the transaction. Earthstone's CEO continued to lead the negotiations with Bold, and about one month after formation of the special committee, Earthstone formally submitted an offer letter to Bold, which included express conditions that the transaction must receive approval from the special committee and from the holders of a majority of the disinterested Earthstone stockholders. Ultimately, the transaction was so approved by the special committee and 99.7% of the Earthstone disinterested stockholders. Plaintiff brought fiduciary duty and related claims challenging the transaction, and the defendants moved to dismiss.

Analysis

In dismissing plaintiff's claims, the court determined that business judgment review was applicable to the transaction under *MFW*, and in applying the roadmap from that case, helped to clarify the timing mandated by *MFW*'s "*ab initio*" requirement:

- MFW*'s roadmap (described here) provides the most conservative approach to protecting director action in any transaction involving a potential controlling stockholder*. The parties had disputed whether EnCap was a controlling stockholder of Earthstone and thus whether *MFW* or *Corwin* standards govern. The former applies to controller transactions and requires both special committee and majority-of-the-minority stockholder approvals meeting specified requirements to invoke business judgement review, while the latter applies to noncontroller transactions and requires only an informed

and uncoerced stockholder approval to invoke business judgment review. The court did not have to decide this issue, however, because the transaction had been structured to comply with the more stringent *MFW* conditions. Thus, business judgement applied to the transaction in either case.

- MFW's "ab initio" *requirement mandates that the controller condition the transaction on final approval by the special committee and a majority of the minority stockholders "before any negotiations [take] place," which is 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 *Olenik* opinion is particularly notable for helping to clarify this timing mandated by the *ab initio* requirement. While the court noted that, consistent with prior decisions, "*ab initio*" requires that the protections be in place at the outset of negotiations, it clarified that they may be agreed to after certain discussions between the parties that are merely "exploratory in nature." Here, Earthstone first included these conditions at the outset of negotiations in its first offer letter to Bold. The fact that Earthstone's CEO engaged in discussions with EnCap and Bold before that point, however, was not fatal to the transaction's satisfaction of the *ab initio* requirement. Although the court labeled these pre-offer discussions as "extensive," they were not negotiations defined by "bargain[ing] toward a desired contractual end" and were "exploratory in nature." Thus, the court found that the *ab initio* condition had been met.

Additionally, *Olenik* includes the following helpful reminders on complying with *MFW* so as to achieve business judgment review even in controller transactions:

- *That a director is appointed to the board by, or has some financial connections to, the purported controller are insufficient, without more, to ruin independence*. Here, both members of the special committee were appointed to their Earthstone board seats by EnCap; however, the court found that fact alone to be insufficient to impeach their independence. In addition, the plaintiff did not make well-pled allegations that the special committee members lacked independence due to financial ties to EnCap through their alleged ownership interests in the EnCap subsidiary directly holding the Earthstone stock because the plaintiff failed to allege the materiality to the special committee members of these membership interests. Similarly, plaintiff's allegations that one special committee member's role as CEO of a company that invested in five companies led by Earthstone's CEO (who was the founder of the EnCap subsidiary) were insufficient to allege that he lacked independence, as there were no well-pled facts to show how the committee member might feel subject to the Earthstone CEO's domination because of the investments.

- *A showing of "gross negligence," which is required to show that the special committee members breached their duty of care in connection with the transaction (and thus failed to meet* MFW *standards), is a "very tough standard" to plead*. The plaintiff alleged that the special committee failed to exercise real bargaining power, permitted the transaction to be dominated by Earthstone management and EnCap and capitulated to the terms of the transaction that the Earthstone CEO and

EnCap favored. The court detailed the special committee's decision-making process, which the court concluded did not amount to a "rubber-stamp" on a "fully-baked deal" as the plaintiff had alleged. Therefore, none of the plaintiff's allegations demonstrated the "gross negligence" required to show that the committee members breached their duty of care.

- *The failure to disclose a financial advisor's reluctance to commit to provide a fairness opinion before the transaction's final terms are agreed to is, in general, not a material omission that would cause the majority-of-the-minority vote to be uninformed under* MFW. The plaintiff alleged several disclosure violations in an attempt to show that the majority-of-the-minority Earthstone stockholder vote was uninformed, and therefore insufficient to invoke business judgment review under *MFW*. This included allegations that the company should have disclosed the special committee's financial advisor's "refusal" to commit to provide a fairness opinion regarding a transaction months before a final agreement was reached, which the plaintiff argued was an acknowledgement that the advisor was not comfortable with the special committee's "push" to get the advisor to move from its initial valuation. The court disagreed, holding that the vote was informed, and noted that it would have been more problematic (and worthy of disclosure) "if [the financial advisor] had committed to provide a fairness opinion [at this time] before knowing the final terms of the Transaction."

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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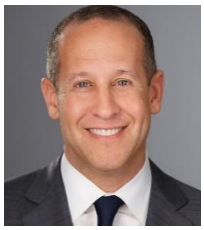

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