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DELAWARE CORPORATE LAW BULLETIN

Delaware Supreme Court Explores Application of *MFW*'s “*Ab Initio*” Requirement in Controlling Stockholder-Related Litigation

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*Refusing to draw a bright-line, the Court focuses on the point at which “substantive economic negotiations” begin in determining whether failure to include *MFW*'s dual procedural protections in the initial offer may not be fatal to pleading-stage dismissal*

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INTRODUCTION

The sustainability and fairness of corporate buyouts involving controlling stockholders traditionally were subject to strict scrutiny by Delaware courts. These transactions generally come in one of three forms: (1) a buyout of public stockholders by the controlling stockholder, (2) a third-party buyout in which the controlling stockholder receives preferential, or “disparate,” treatment, or (3) a transaction between two corporations, each controlled by the same stockholder. The discussion that follows applies equally to each of these types of transactions.

In 1983, in *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), the Delaware Supreme Court announced that the entire fairness standard of review—Delaware’s most intrusive standard of review—governs controlling stockholder related litigation, with the difficult burden of proving entire fairness placed on the controlling stockholder. Over ten years later, in *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110 (Del. 1994) (“*Lynch*”), the Delaware Supreme Court added that if the transaction is approved by *either* “an independent committee of directors or an informed majority of minority shareholders,” the burden of proof shifts to plaintiff stockholders to establish the unfairness of the transaction.

It became standard practice, following *Lynch*, for transaction planners to utilize committees of independent directors in the approval process for buyouts involving controlling stockholders. However, the benefits offered by *Lynch* were somewhat limited by the courts’ reluctance to grant a burden shift until a full record was developed either in connection with a summary judgment motion or, more frequently, after a trial on the merits. Thus, because controlling stockholders could not obtain pleading-stage dismissal, every claim had settlement value. Further, legal advisers were reluctant to utilize the other procedural device offered in *Lynch* to obtain the burden shift—approval of the transaction by a “majority of minority shareholders”—for fear of the additional bargaining leverage provided to a single or small group of stockholders.

In recent years, the Delaware courts have considered the circumstances, if any, under which the deferential business judgment standard of review—the polar opposite of entire fairness—may be available in controlling stockholder related litigation. While the Delaware Supreme Court firmly established, in 2013, that the parties to such a transaction may structure the approval process so as to receive the benefits of the business judgment presumption—primarily, pleading-stage dismissal—the courts continue to wrestle with some of the more important details. Two recent decisions of the Delaware Supreme Court, while refusing to establish a bright-line rule to guide

transaction planners, help to clarify the procedural steps necessary to achieve the shift from entire fairness to business judgment.

A. *The MFW Playbook*

Nearly twenty years after *Lynch*, the Delaware Court of Chancery (“*Chancery Court*”) ruled for the first time in *In re MFW Shareholders Litigation*, 67 A.3d 496 (Del. Ch. 2013) (“*MFW I*”), that a controlling stockholder-led buyout will be reviewed under the business judgment rule when conditioned on approval by *both* a special committee of independent directors *and* an informed vote of the holders of a majority of the shares not owned by the controlling stockholder. The following year, the Delaware Supreme Court affirmed *MFW I* in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) (“*MFW II*”). The *MFW II* Court promulgated a six-factor test (which is familiarly referred to as the “*MFW Playbook*”) as a prerequisite for availability of business judgment review in controlling stockholder-related litigation:

[1] The [controlling stockholder] conditions the procession of the transaction on the approval of both a special committee and a majority of the minority stockholders; [2] the special committee is independent; [3] the special committee is empowered to freely select its own advisors and say no definitively; [4] the special committee meets its duty of care in negotiating a fair price; [5] the vote of the minority is informed; and [6] there is no coercion of the minority.

Importantly, the *MFW II* Court stipulated that the first prong of the MFW Playbook—approval of the proposed transaction by *both* a special board committee *and* disinterested stockholders (“*Dual Protections*”)—must be announced by the controlling stockholder “before any negotiations took place.” This has become known as the “*ab initio*” requirement.

B. *The Ab Initio Requirement*

Following *MFW II*, several Chancery Court decisions—in the context of pleading-stage dismissals—addressed the point in time at which the Dual Protections must be agreed upon by the controlling stockholder to satisfy the *ab initio* requirement:

- In Oral Argument on Defendants’ Motion to Dismiss, *Swomley v. Schlecht*, No. 9355-VCL, 2014 WL 4470947 (Del. Ch. Aug. 27, 2014) (“*Swomley*”), *aff’d*, 128 A.3d 992 (Del. 2015), Vice Chancellor J. Travis Laster reasoned that the Dual Protections, though not unconditionally agreed to in the controlling stockholder’s initial buyout proposal, were in place “before any negotiations took place” between the controlling stockholder and an independent board committee. On this basis, the Vice

Chancellor applied business judgment review in granting the controlling stockholder's motion to dismiss a stockholder challenge to the transaction. (For a discussion of *Swomley*, see Robert S. Reder & Lauren Messonnier Meyers, *Delaware Supreme Court Affirms Pleading-Stage Dismissal of Control Stockholder Buyout Litigation*, 69 VAND. L. REV. EN BANC 17 (2016)).

- Next, in *In re Synutra Int'l Inc. S'holder Litig.*, No. 2017-0032-JTL, 2018 WL 705702 (Del. Ch. Feb. 2, 2018), *aff'd*, 195 A.3d 754 (Del. 2018) ("*Synutra I*"), the controlling stockholder's initial proposal was silent as to the Dual Protections. Two weeks later, before any negotiations took place, the controlling stockholder sent a revised proposal explicitly conditioned on the Dual Protections. Vice Chancellor Laster found that this timing satisfied the *ab initio* requirement and, applying business judgment review, granted defendants' motion to dismiss. (For a discussion of *Synutra I*, see Robert S. Reder, *Chancery Court Again Grants Early Dismissal of Litigation Challenging Control Stockholder-Led Buyout*, 72 VAND. L. REV. EN BANC 11 (2018)).
- Finally, in *Olenik v. Lodzinski*, No. 2017-0414-JRS, 2018 WL 3493092 (Del. Ch. July 20, 2018), *aff'd in part, rev'd in part*, No. 392, 2018, 2019 WL 1497167 (Del. Sup. Ct. Apr. 5, 2019) ("*Olenik I*"), Vice Chancellor Joseph R. Slight III recognized, for purposes of the *ab initio* requirement, an "important distinction" between exploratory "discussions" and "negotiations." The Vice Chancellor held that a formal proposal, which expressly conditioned the transaction on the Dual Protections, satisfied the *ab initio* requirement despite ten months of "extensive" preliminary discussions *preceding* the formal offer. In granting the controlling stockholder's motion to dismiss, the Vice Chancellor was reassured by the two months of substantial negotiations that took place *after* submission of the formal offer. (For a discussion of *Olenik I*, see Robert S. Reder & Ashleigh C. Bennett, *Chancery Court Analyzes MFW's "Ab Initio" Requirement in Controlling Stockholder Litigation*, 72 VAND. L. REV. EN BANC 117 (2019)).

The Delaware Supreme Court has entertained appeals of each of these decisions, resulting in two affirmances and one reversal. The first affirmance, a terse opinion upholding the pleading-stage dismissal in *Swomley*, does not tell us much. By contrast, the opinions in *Flood v. Synutra International Inc.*, 195 A.3d 754 (Del. 2018) ("*Synutra IP*"),

affirming *Synutra I*, and in *Olenik v. Lodzinski*, No. 392, 2018, 2019 WL 1497167 (Del. Sup. Ct. Apr. 5, 2019) (“*Olenik II*”), reversing *Olenik I*, feature lengthy discussions of the *ab initio* requirement. In essence, these opinions reflect the traditional reluctance of the Delaware Supreme Court to adopt bright-line rules for litigation over the fiduciary duties of corporate actors. Rather, as *Synutra II* and *Olenik II* demonstrate, the particular facts of a case, even at the early pleading stage, are critical to the determination whether the *ab initio* requirement has been satisfied.

I. FACTUAL BACKGROUNDS

A. *Synutra*

Liang Zhang (“*Zhang*”), the chief executive officer of Synutra International Inc. (“*Synutra*”), beneficially owned 63.5% of Synutra’s shares. On January 14, 2016, Zhang submitted a letter to Synutra’s board of directors (“*Synutra Board*”) proposing to acquire Synutra’s other outstanding shares at \$5.91 per share in cash (“*Initial Proposal*”). The Initial Proposal failed to condition the proposed transaction on the Dual Protections. At a meeting held one week later, but before the Synutra Board gave any substantive evaluation to the Initial Proposal, the Synutra Board formed a special committee comprised of three independent directors (“*Synutra Special Committee*”). On January 30, a little more than two weeks after delivery of the Initial Proposal, Zhang submitted a second letter offering the same price per share, but this time expressly conditioning the proposed transaction on approval by both the Synutra Special Committee and “holders of a majority of the voting stock not controlled by Zhang.” (“*Revised Proposal*”). No negotiations took place before Zhang’s submission of the Revised Proposal.

Thereafter, the Synutra Special Committee retained independent legal counsel and hired Houlihan Lokey (“*Houlihan*”) as its independent financial advisor. Over a seven month period extending from March to September, Houlihan met with management, obtained financial projections, provided advice to the Synutra Special Committee, and initiated a market check. The market check proved fruitless, due in large part to Zhang’s controlling position. On September 8, the Synutra Special Committee directed Houlihan to engage in price negotiations with Zhang. Zhang promptly raised his offer to \$6.05 per share, representing a 58% premium to the trading price at the time the Initial Proposal was announced. The Synutra Special Committee accepted the increased offer on September 22, and recommended approval to the Synutra Board on November 17.

Following signing of a merger agreement, on April 28, 2017, the disinterested stockholders voted in favor of the buyout.

A former stockholder of Synutra challenged the fairness of the buyout in Chancery Court. The primary issue before Vice Chancellor Laster was the operation of *MFW II*'s *ab initio* requirement in light of Zhang's failure to include the Dual Protections in the Initial Proposal. In this connection, the Vice Chancellor emphasized that only two weeks later, after the Synutra Board formed the Synutra Special Committee but before any negotiations over the proposed buyout took place, Zhang sent the Revised Proposal explicitly conditioned on the Dual Protections. In the Vice Chancellor's opinion, this timing satisfied the *ab initio* requirement because the promptness with which the Revised Proposal was delivered prevented Zhang "from using the [*MFW*] conditions as bargaining chips." Applying business judgment review, the Vice Chancellor granted defendants' motion to dismiss.

B. Olenik

Oak Valley Resources, LLC ("*Oak Valley*"), a "holding company . . . for investment opportunities in upstream oil and gas companies" founded by Frank Lodzinski, was the largest stockholder of Earthstone Energy, Inc. ("*Earthstone*"), an independent "upstream" oil and gas company with assets in Texas and North Dakota. Oak Valley owned 41.1% of Earthstone's outstanding shares and was entitled to appoint seven members of Earthstone's nine-member board of directors ("*Earthstone Board*"). Lodzinski served as Earthstone's chairman and chief executive officer. EnCap Investments, L.P. ("*EnCap*"), a "private equity firm," in turn owned 57.3% of Oak Valley, making it Earthstone's controlling stockholder. EnCap also owned 95.9% of Bold Energy III LLC ("*Bold*").

Earthstone "was a mature company with increasing revenue . . . but with limited undeveloped resources," while Bold was "an early stage oil and gas company" that, "[a]s compared to Earthstone, . . . generated far less revenues but owned approximately three-times more undeveloped resources" in Texas and New Mexico. Beginning in November 2015, as part of Earthstone's search for potential acquisition targets, Lodzinski reached out to EnCap to discuss its portfolio companies, including Bold. Substantial discussions, including the exchange of valuations, among Earthstone management and representatives of EnCap and Bold concerning a potential Earthstone-Bold combination continued over the next nine months. During this period, Earthstone was permitted to conduct significant due diligence on Bold. In July 2015, the Earthstone Board formed a special committee composed of two independent directors ("*Earthstone Special*").

Committee) to evaluate whether to make a formal offer for Bold. The Earthstone Special Committee’s mandate included the right to “[r]eject the potential transaction, cease further negotiations and ‘walk-away.’”

A month later, Earthstone submitted a formal proposal (“*Offer Letter*”) to acquire Bold, explicitly conditioned on approval by both the Earthstone Special Committee and a majority of Earthstone’s public stockholders. Two months of back-and-forth negotiations over the proposed equity split ensued, with Lodzinski serving as the Earthstone Special Committee’s lead negotiator. Ultimately, the two companies agreed on a definitive combination agreement that was approved by the Earthstone Special Committee, the Earthstone Board, and the owners of 99.7% of the non-affiliated shares voting on the transaction. The combination was well-received by the market, as “Earthstone’s stock price rose 27% on the day of the announcement” and continued to rise during the period leading up to the stockholders’ meeting.

An Earthstone stockholder challenged the transaction in Chancery Court, alleging the Earthstone Board approved an unfair transaction favoring the interests of EnCap, the controlling stockholder over those of the public stockholders. Plaintiff argued for application of the entire fairness, rather than the business judgment, standard of review because the Dual Protections were not agreed upon in time to satisfy the *ab initio* requirement. In granting defendants’ motion to dismiss, Vice Chancellor Slight recognized, for purposes of the *ab initio* requirement, an “important distinction” between exploratory “discussions” and “negotiations.” The Vice Chancellor was reassured by the two months of substantial negotiations that took place *after* submission of the formal offer: “By conditioning the first offer in this manner,” the Vice Chancellor reasoned, “the Special Committee made clear to Bold and EnCap that the ‘provision of the transaction’ would be subject to these terms. That is precisely what *MFW* requires.”

II. THE DELAWARE SUPREME COURT’S ANALYSES

The Delaware Supreme Court agreed with Vice Chancellor Laster’s decision to dismiss the claims against the controlling stockholder in *Synutra I*, but rejected Vice Chancellor Slight’s dismissal of the claims brought in *Olenik II*. The facts pled by the respective plaintiffs in each case drove these disparate results.

A. *Synutra II*—*Bright-Line Rule Rejected*

The plaintiff in *Synutra II* contended that because the Initial Proposal failed to include the Dual Protections, Vice Chancellor Laster

erred in applying business judgment review. Relying on language in *MFW I* and *MFW II* that the Dual Protections must be present “from the beginning” and “from inception,” the plaintiff urged application of a bright-line rule, contending that “negotiations must tautologically be in the first offer.”

Chief Justice Strine, writing for the majority in *Synutra II*, rejected a bright-line approach requiring that a “controller must include the conditions in its ‘first offer’ or else lose out on the business judgment rule.” In the majority’s view, this position disregarded that the Revised Proposal, sent two weeks *after* the Initial Proposal but *before* any economic negotiations occurred, expressly conditioned the proposed transaction on the Dual Protections. Instead, the majority adopted Vice Chancellor Laster’s less rigid reading that “[a] process meets the *ab initio* requirement when the controller announces the conditions ‘before any negotiations took place.’”

Acknowledging that the various formulations used in previous Delaware decisions—“*ab initio*,” before the ‘proceeding of the transaction,’ ‘from inception,’ ‘from the time of the controller’s first overture,’ and ‘upfront,’—are “ambiguous,” the majority based its rejection of a bright-line rule on both the ordinary meaning of “from the beginning” as well as the policy underlying the *MFW* Playbook:

- *First*, focusing on the operative language, the majority interpreted “from the beginning” broadly, with a view to how the term is used “in everyday speech, when that term is applied to a multi-stage process of human events with periods of time leading to an ultimate conclusion.” For example, the Chief Justice wrote: “[a] goal scored in the fifth minute of a 90-minute match would be referred to as a goal at the beginning of the match,” and “[t]he beginning of a novel is not the first word, but the first few chapters that introduce the reader to the characters, setting, and plot.” On this basis, the majority concluded an ordinary person would find that Zhang conditioned the proposed transaction “on *MFW*’s dual requirements in the beginning stages of the process that led to the merger.”
- *Second*, turning to policy considerations, the majority explained that the *ab initio* requirement is intended to prevent the Dual Protections from being used by a controlling stockholder as bargaining chips “in substitution for economic concessions” Post-*Lynch*, “[c]ontrollers were reluctant to condition mergers on a majority-of-the-minority vote upfront because it ‘added an element of transactional risk without much liability-insulating compensation in exchange.’” In an effort to “avoid one of Lynch’s adverse consequences—using a majority-of-the-minority vote as

a chit in economic negotiations with a Special Committee—*MFW* sanctions review under the favorable business judgment rule if [the Dual Protections] are established upfront.” As such, the controlling stockholder must “self-disable before the start of substantive negotiations.” This approach incentivizes controlling stockholders who wish to receive business judgment review to guarantee the Dual Protections before negotiations begin, thereby enabling the Special Committee to bargain on price and other substantive deal terms rather than procedural matters.

The majority recognized that its approach “may give rise to close cases.” However, because:

[O]ur Court of Chancery is expert in the adjudication of corporate law cases . . . [W]hen a plaintiff has pled facts that support a reasonable inference that the two procedural protections were not put in place early and before substantive economic negotiation took place, the Court of Chancery can be trusted to apply appropriate pleading stage principles and refuse to dismiss the case.

In a lengthy dissent, Justice Karen L. Valihura advocated for a “bright-line” approach. In her view, “‘*ab initio*’ means from the controller/buyer’s first written proposal,” leading her to conclude that Vice Chancellor Laster “mov[ed] the *ab initio* needle from ‘up front’ and ‘from inception’ of the first offer to holding that ‘a process meets the *ab initio* requirement when the controller announces the conditions ‘before any negotiations took place.’” In rejecting the fact-based inquiry embraced by the majority, Justice Valihura opined that the *MFW* Playbook “was intended to be a clear roadmap in controller buyouts and corporate counsel who routinely practice in the area are familiar with it.” By contrast, she noted, “[t]he Majority’s adoption of the ‘when the negotiations begin’ test invites factual inquiries that defeat the purpose of what should be more of a bright line and narrower pathway for pleading-stage dismissals in this context.”

B. *Synutra II*—*Ab Initio* Requirement Satisfied

In determining whether the record before the Chancery Court in *Synutra I* demonstrated that the *ab initio* requirement was in fact satisfied, the majority focused on the sequence of events. Specifically, Zhang delivered the Revised Proposal *before* the *Synutra* Special Committee held its first meeting, hired its advisors, or discussed the terms of his offer with Zhang. Most important, no negotiations took place before Zhang submitted the Revised Proposal. And, further, “the early second offer was followed by several months of due diligence that occurred before any bargaining took place between the Special

Committee and Zhang over the economic terms of the proposed transaction.” On this basis, the majority concluded that “Zhang thus conditioned the buyout at the beginning of the process and is therefore entitled review under the business judgment rule standard.”

C. Olenik II—Ab Initio Requirement Not Satisfied

At the outset of its analysis, the *Olenik II* Court noted the “pragmatic approach” adopted by the majority in *Synutra II*, emphasizing that even though the Initial Proposal did not contain the Dual Protections, Zhang submitted the Revised Proposal reflecting the Dual Protections “at the germination stage of the Special Committee process” when it “ha[d] not commenced substantive economic negotiations with the controller.” The remainder of the analysis contrasted the sequence of events in *Olenik I*.

Next, the *Olenik II* Court explained that “based on our review of the plaintiff’s complaint, as informed by our *Synutra* decision,” “the well-pled facts ‘support a reasonable inference’ that the *MFW* requirements ‘were not put in place early and before substantive economic negotiation took place.’” Rather, “the well-pled facts in the complaint support a pleading-stage inference that the preliminary discussions transitioned to substantive economic negotiations when the parties engaged in a joint exercise to value Earthstone and Bold” before delivery of the Offer Letter. This “joint exercise” included two presentations made by Earthstone management to EnCap containing valuations of Bold at \$305 and \$335 million, respectively. According to the Court, “these valuations set the field of play for the economic negotiations to come by fixing the range in which offers and counteroffers might be made.” Further, the Court noted, at a meeting of the Earthstone Board held before delivery of the Offer Letter, “management presented a transaction with an already presumed timeline (to be announced in ‘Q3/Q4’ of that year) and an ‘assumed’ price of \$333 million.”

On this basis, the *Olenik II* Court viewed plaintiff’s complaint as establishing that the parties “were engaged in substantive economic discussions during some of the eight months before the *MFW* protections were put [in] place.” Accordingly, the Court reversed Vice Chancellor Slight’s pleading-stage dismissal and returned the case to the Chancery Court.

CONCLUSION

One could imagine that *Olenik II* was something of an “I told you so” moment for Justice Valihura, who warned the *Synutra II* majority

in her dissent that “factual inquiries” would follow their decision not to adopt a bright-line rule to govern the *MFW* Playbook’s *ab initio* requirement. To be fair, however, it would have been out of character for the Delaware Supreme Court to adopt such a bright-line approach.

In light of these two decisions, transaction planners are well-advised to make sure that the *MFW* Playbook’s Dual Protections are communicated to the target company’s representatives sooner rather than later in connection with controlling stockholder-related transactions, and preferably as part of the initial price offer. While *Synutra II* does leave some room for the controlling stockholder to “test the waters” or retain experienced legal counsel before committing to the Dual Protections, *Olenik II* clarifies that the distinction drawn by the Vice Chancellor in *Olenik I* between “discussions” and “negotiations” is not one on which transaction planners may comfortably rely. Retaining the ability to obtain pleading-stage dismissal certainly outweighs whatever benefits may accrue from delaying agreement on the Dual Protections. Thus, at the very latest, the Dual Protections must be put in place “early in the process and before there has been any economic horse trading.” And as *Olenik II* teaches, any discussions regarding valuation are particularly problematic.