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Olenik v. Lodzinski: More on Structuring Controlling Stockholder Buyouts

The Delaware Supreme Court has provided transaction parties and practitioners with additional guidance on structuring controlling stockholder buyouts. Specifically, the Court provided clarity concerning the point in time certain conditions must be in place for restoration of the presumption of the business judgment rule.

By John Mark Zeberkiewicz and Robert B. Greco

In *Olenik v. Lodzinski*,[1] the Delaware Supreme Court provided further guidance regarding the circumstances under which the deployment of procedural protective devices pursuant to the so-called *MFW* standard—namely, the transaction's negotiation and approval by an independent special committee and its adoption by a majority-of-the-minority vote—can operate to restore the presumption of the business judgment rule to a controlling stockholder buyout. Specifically, the Court provided additional clarity around the point in time in the process by which the controller must affirm that its transaction will not proceed without those conditions in place.

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Background

The Court's opinion in *Olenik* is the most recent installment in a series of rulings on controlling stockholder buyouts, commencing with the 1994 opinion in *Kahn v. Lynch Communication Systems, Inc.*[2] In *Lynch*, the Court held that the rigorous entire fairness standard of review—requiring an inquiry into the "fair price" and "fair process" elements of a transaction—is the exclusive standard of review applicable to a cash-out merger by a controlling or dominating stockholder.[3] Under the *Lynch* Court's holding, in a controlling stockholder buyout, the initial burden of proof on fairness is placed on the defendants, but the transaction's approval by a fully functioning committee of independent directors or by an uncoerced, fully informed vote of a majority-of-the-minority stockholders could shift the burden of proof to the plaintiffs.[4] "Nevertheless," the *Lynch* Court held,

> even when an interested cash-out merger transaction receives the informed approval

> of a majority of minority stockholders or an independent committee of disinterested directors, an entire fairness analysis is the only proper standard of judicial review.[5]

Although the shift in the burden of proof may have been designed to encourage transaction planners to deploy procedural mechanisms designed to promote fair outcomes for minority stockholders, it did not, in and of itself, provide a material benefit in terms of allowing for transaction litigation to be dispensed with at a preliminary stage. As the Court of Chancery has noted, "[t]he practical effect" of the burden shift is "slight," given that it only applies in rare circumstances where "the evidence is in equipoise."[6] "Certainly, at a pre-trial stage, it is hard to imagine how this shift in burden would change the outcome of a typical motion for dismissal for failure to state a claim or for summary judgment."[7]

While the *Lynch* standard continued to apply to controlling stockholder buyouts effected by statutory merger, cases in the Court of Chancery allowed for more favorable standards of review to be applied to controlling stockholder tender offers followed by a back-end merger.[8] In *In re Cox Communications, Inc. Shareholders Litigation*, the Court of Chancery, ruling on an objection to a fee request, pointed out the disconnect in the law applicable to controlling stockholder buyouts effected through a tender offer followed by a back-end merger, and those effected by statutory merger.[9] With respect to the latter, the Court observed that the *Lynch* standard made

> it impossible for a controlling stockholder ever to structure a transaction in a manner that will enable it to obtain dismissal of a complaint challenging the transaction,

with the result that "each *Lynch* case has settlement value, not necessarily because of its merits but because it cannot be dismissed."[10]

The *Cox* Court accordingly proposed a reform in Delaware law that would allow for the invocation of the business judgment rule in cases in which a going-private merger with a controller "mirrored *both* elements of an arm's-length merger" through the approval by disinterested directors *and* disinterested stockholders, noting that those two elements would have to be "complementary and not substitutes."[11] The Court argued that its reform would not only "provide an incentive for transactional planners to use the transactional structure that virtually all informed commentators believe is most advantageous to minority stockholders," but would also "bring together both lines of [Delaware's] going-private jurisprudence in a sensible manner, providing stockholders with substantial procedural guarantees of fairness that work in tandem while minimizing the rote filing of makeweight cases."[12]

Years later, in *In re CNX Gas Corp. Shareholders Litigation*, the Court of Chancery, after reviewing the disparate lines of cases governing controlling stockholder buyout transactions generally, applied what it referred to as the "unified standard" articulated in *Cox Communications*, stating that

> if a first-step tender offer is both (i) negotiated and recommended by a special committee of independent directors and (ii) conditioned on the affirmative tender of a majority of the minority shares, then the business judgment standard of review presumptively applies to the freeze-out transaction.[13]

While much was written in these early opinions regarding the composition and efficacy of the special committee as well as the adequacy of the disclosure to stockholders, there was little guidance on the manner in which the majority-of-the-minority condition had to be imposed.

Imposition of Procedural Protective Devices

In its 2013 opinion in *In re MFW Shareholders Litigation*, the Court of Chancery, while noting that *Lynch* had been read to suggest that a controlling stockholder proposing to merge with the company

would receive "no extra legal credit" for consenting to *both* of the minority stockholder protections, nevertheless found that the question had "never been squarely presented to [the Delaware] courts."[14] The *MFW* Court ultimately concluded that

> when a controlling stockholder merger has, *from the time of the controller's first overture*, been subject to (i) negotiation and approval by a special committee of independent directors fully empowered to say no, and (ii) approval by an uncoerced, fully informed vote of a majority of the minority investors, the business judgment rule standard of review applies.[15]

The Supreme Court affirmed the Court of Chancery's opinion in *MFW*, albeit using slightly different terminology, noting that, for the business judgement standard to be invoked, the controlling stockholder merger would have to be "conditioned *ab initio*" upon the two conditions.[16]

Despite the Supreme Court's clear articulation of the *MFW* standard, a few questions regarding its application remained unanswered, particularly with regard to the point in time at which the controller had to communicate its consent to the imposition of the conditions. The Supreme Court first squarely addressed the question in *Flood v. Synutra International, Inc.*[17] In *Synutra*, the plaintiff argued that the defendants were not entitled to invoke the protection of the business judgment rule under *MFW* since the controller's first expression of interest was not subject to the two *MFW* conditions. The Supreme Court rejected that argument, stating that

> what is critical for the application of the business judgment rule is that the controller accept 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.[18]

The *Synutra* Court noted that the controller in that case promptly had course-corrected, subjecting its transaction to the two *MFW* conditions before any of the economic negotiations had occurred—and even before the special committee had retained counsel and commenced its substantive deliberations.[19] Thus, the *Synutra* Court was satisfied that the controller had satisfied the "*ab initio*" requirement.[20]

Demarcating the Line of Substantive Economic Negotiations

The Supreme Court's most recent statement on the "*ab initio*" requirement appears in *Olenik*. The dispute in *Olenik* arose out of the stock-for-stock business combination between Earthstone Energy, Inc. (Earthstone) and Bold Energy III LLC (Bold), both of which were alleged to be controlled by EnCap Investments, L.P.[21] The Earthstone-Bold transaction, which resulted in the legacy Earthstone stockholders obtaining roughly 40 percent of the combined company, was first formally proposed by a special committee of Earthstone's independent directors in a written offer letter dated August 19, 2016.[22] In that letter, the Earthstone special committee stated that any transaction between Earthstone and Bold would be subject to the committee's approval as well as a majority-of-the-minority vote.[23] The Court noted, however, that the Earthstone-Bold transaction had "its roots in mid-2015 when EnCap began looking for ways to sell Bold or take it public" and that in the months leading up to Earthstone's formal proposal, Earthstone's chief executive officer had engaged in discussions with EnCap regarding an opportunity to combine Earthstone and Bold.[24]

The plaintiff, a stockholder of Earthstone, challenged the transaction, arguing that EnCap Investments, L.P., as controller, had caused Earthstone's minority stockholders to approve the transaction on the basis of misleading disclosures. The defendants moved to dismiss on *MFW* grounds, noting that the transaction was appropriately made subject to the two *MFW* conditions.[25] In dismissing the plaintiff's claims, the Court of Chancery found that the initial

offer letter from Earthstone to Bold, which was sent on August 19, 2016, effectively constituted the controller's first overture for *MFW* purposes. That offer letter, the Court of Chancery stated, "announced and made clear from the outset—at the start of negotiations on the proposal—that any transaction between Earthstone and Bold" would be subject to the twin procedural protections.[26]

Reviewing the Court of Chancery's decision *de novo*, the Delaware Supreme Court found that the lower court erred when it found that the *MFW* protections had been in effect from the outset of the transaction. Although recognizing that the Court of Chancery correctly had determined that "preliminary discussions" between a controller and the controlled company do not "pass the point of no return" for purposes of the imposition of the two *MFW* conditions, the Court found that the conditions were not put in place before the substantive deal terms of the Earthstone-Bold transaction occurred.[27] The Court catalogued several discussions and other matters relating to the transaction that were alleged to have occurred or been raised before the August 2016 offer letter was submitted. These included: (1) EnCap's providing Earthstone in November 2015 the presentation that its investment banker had used to market Bold; (2) Earthstone's December 2015 entry into a confidentiality agreement with Bold, along with its gaining access to due diligence materials; (3) Earthstone management's meetings in April 2016 with representatives of EnCap to discuss the potential Bold transaction; (4) Earthstone management's May 2016 presentations to EnCap regarding the potential equity valuation of Bold; and (5) the conduct of due diligence meetings among Earthstone, EnCap and Bold throughout June and July 2016.[28]

The Court recognized that some of the "early interactions" between Earthstone and Bold could be characterized as "preliminary discussions"—and therefore not sufficient to eliminate the potential invocation of the *MFW* protections—but nevertheless found that the plaintiffs had adequately pled that the discussions among the parties had transitioned into substantive economic negotiations once they began engaging in the exercise to value Earthstone and Bold.[29] The Court found it was reasonable to infer that the valuation presentations "set the field of play" for the economic negotiations to come by fixing the range in which offers and counteroffers might be made."[30]

Key Takeaways

The Supreme Court's opinion in *Olenik* provides transaction parties and practitioners additional guidance with respect to structuring controlling stockholder buyouts. While the *Olenik* Court again eschewed a bright line test for determining the point in time at which the controller must self-disable by conditioning a transaction on the twin *MFW* conditions, it did reiterate that the conditions have to be in place before the parties engage in discussions over substantive deal terms. Transaction parties and their counsel should be mindful, however, that, depending on the facts and circumstances, discussions over substantive deal terms may be alleged to arise not only through negotiations over pricing or indications of interest, but also through the sharing of information on valuation and other terms. Thus, a controlling stockholder seeking to avail itself of favorable treatment under *MFW* should make clear, in any circumstance in which it is contemplating engaging in a transaction with the controlled company, that no transaction will proceed in the absence of the *MFW* protections before engaging in discussions over, or sharing information with respect to, the pricing or other material terms of the deal. This would include engaging in any discussions or sharing materials that would "set the field of play" of valuation for the ultimate transaction.

Notes

1. 2019 WL 1497167, --- A.3d --- (Del. Apr. 5, 2019).
2. 638 A.2d 1110 (Del. 1994).
3. *Id.* at 1116.
4. *Id.*
5. *Id.*

6. *In re Cysive, Inc. S'holders Litig.*, 836 A.2d 531, 548 (Del. Ch. 2003); *see also* In re Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 617 (Del. Ch. 2005) (characterizing the burden shift as "a modest procedural benefit").
7. *Cysive*, 836 A.2d at 548.
8. *See, e.g.*, Solomon v. Pathe Commc'ns Corp., 1995 WL 250374 (Del. Ch. Apr. 21, 1995) (holding that a controlling stockholder had no duty to provide minority stockholders with a "fair price" in a non-coercive tender offer), *aff'd*, 672 A.2d 35 (Del. 1996); In re Siliconix Inc. S'holders Litig., 2001 WL 716787 (Del. Ch. June 19, 2001) (declining to apply entire fairness standard of review to tender offer conditioned on majority-of-the-minority condition); In re Aquila Inc., 805 A.2d 184 (Del. Ch. 2002) (declining to apply entire fairness to a controlling stockholder exchange offer subject to a majority-of-the-minority tender condition and coupled with a commitment on the part of the controller to effect a short-form merger on the same terms as the offer); In re Pure Res., Inc., S'holders Litig., 808 A.2d 421 (Del. Ch. 2002) (indicating that entire fairness would not apply to a controlling stockholder exchange offer if the offer was subject to negotiation by a duly empowered special committee of independent directors, a non-waivable majority-of-the-minority tender provision, and a commitment by the controller to consummate a short-form merger on the same terms as the exchange offer).
9. 879 A.2d 604.
10. *Id.* at 606.
11. *Id.* at 607.
12. *Id.* at 606–07.
13. 4 A.3d 397, 414 (Del. Ch. 2010).
14. 67 A.3d 496, 500–01 (Del. Ch. 2013), *aff'd sub nom.* Kahn v. M & F Worldwide Corp., 88 A.2d 635 (Del. 2014). The Court elaborated: "Although admitting that there is language in prior Supreme Court decisions that can be read as indicating that there are no circumstances when a merger with a controlling stockholder can escape fairness review, the court concludes that this language does not constitute a holding of our Supreme Court as to a question it was never afforded the opportunity to answer. In no prior case was our Supreme Court given the chance to determine whether a controlling stockholder merger conditioned on both independent committee approval and a majority-of-the-minority vote should receive the protection of the business judgment rule." *Id.* at 502.
15. *Id.* (emphasis added). Later in the opinion, the Court dilated further upon the structural protections, stating: "The business judgment rule is only invoked if: (i) the controller conditions the procession of the transaction on the approval of both a special committee and a majority of the minority stockholders; (ii) the special committee is independent; (iii) the special committee is empowered to freely select its own advisors and to say no definitively; (iv) the special committee meets its duty of care; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority." The Court then observed that a stockholder plaintiff would be entitled to plead facts to support a rational inference that one or more of the conditions was lacking and, as a result, could proceed to discovery. If the plaintiff's discovery were to lead to triable issues of fact in respect of the conditions, the Court noted, the plaintiff would then proceed to trial on substantive fairness." *Id.* at 535.
16. *M & F Worldwide*, 88 A.3d at 644.
17. 195 A.3d 754 (Del. 2018).
18. *Id.* at 756.
19. *Id.*
20. Dissenting from the majority's decision in *Synutra*, Justice Valihura argued that the majority's focus on the commencement of negotiations would only "invite[] 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." *Id.* at 769 (Valihura, J., dissenting). Although conceding that the term "*ab initio* . . . lacks some precision in the abstract," Justice Valihura argued that, viewed in the *MFW* context, it was meant to refer to "the time of the controller's first written proposal." *Id.* at 773.
21. The defendants objected to the characterization of EnCap as Earthstone's controlling stockholder, noting that the EnCap-affiliated stockholder owned only 41 percent of Earthstone's outstanding stock from and after the time of Earthstone's first formal proposal.
22. 2019 WL 1497167, at *5–6.
23. The fact pattern in *Olenik* differs from the customary fact pattern in which a controlling stockholder is proposing a freeze-out. The customary *MFW* framework requires that

the *controller* subject itself to the conditions at the time it makes its offer. In *Olenik*, it was the controlled company's special committee that imposed the conditions. Despite this distinction, the Supreme Court operated under the traditional *MFW* framework, noting that "the same principles" applicable to a controlling stockholder buyout "apply whether the controller is directly or indirectly exerting its influence over the transaction," and observing that the technical failure of the conditions to be imposed by the controller made no difference to the analysis, since "EnCap indirectly controlled Earthstone and appeared to agree with the special committee's insistence on the MFW conditions." *Id.* at *8 nn.50, 58.

24. *Id.* at *2–3.
25. The defendants separately moved to dismiss the claims on the grounds that, because EnCap could not fairly be characterized as a controller, the transaction should be dismissed under the *Corwin* doctrine applicable in transactions in which a controller does not appear on both sides. The Court of Chancery stated: "Because I am satisfied that Earthstone's decision to employ the *MFW* framework was well-executed by all concerned, I need not decide whether [EnCap] was Earthstone's controlling stockholder because, even if it was, business judgment deference is the appropriate standard by which to evaluate the Transaction, even at the pleadings stage." Olenik v. Lodzinski, 2018 WL 3493092, at *14 (Del. Ch. July 20, 2018).
26. *Id.* at *15.
27. *Olenik*, 2019 WL 1497167, at *8.
28. *Id.* at *9.
29. *Id.*
30. *Id.* The Court then found that, based on the complaint, the initial valuations did indeed set the field of play, as Earthstone's first offer as well as its final offer were within the bands of valuation reflected in the first and second presentations that Earthstone management made to EnCap.