# Court of Chancery's Post-'*Olenik*' Interpretation of the '*Ab Initio*' Requirement

## Since *Olenik*, each of the three published Court of Chancery opinions substantively addressing whether transacting parties met the *ab initio* requirement held that the parties failed. This article elucidates the contours of the *ab initio* requirement by mining fact-based guideposts from those three cases.

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In *Kahn v. M&F Worldwide*, 88 A.3d 635 (Del. 2014), and its progeny, Delaware courts established that transactions subject to the entire fairness standard of review due to the presence of a conflicted controlling stockholder will nonetheless receive business judgment rule deference if the deal in question is conditioned *ab initio* on two well-known procedural protections: approval by a fully empowered special committee of disinterested directors, and a fully informed, uncoerced vote of a majority of disinterested stockholders. The Delaware Supreme Court's most recent definitive explanation of what *MFW*'s *ab initio* element requires arrived just over a year ago in *Olenik v. Lodzinski*, 208 A.3d 704 (Del. 2019), where the high court explained that "*ab initio*" means "early and before substantive economic negotiation [takes] place." Since *Olenik*, however, each of the three published Court of Chancery opinions substantively addressing whether transacting parties met the *ab initio* requirement held that the parties failed. This article elucidates the contours of the *ab initio* requirement by mining fact-based guideposts from those three cases.

The first case, *Arkansas Teacher Retirement System v. Alon USA Energy*, 2019 WL 2714331 (Del. Ch. June 28, 2019), involved a 48% controlling stockholder's buyout of the remaining 52% of the target company's stock. Before the parties conditioned the deal on *MFW* protections, the target's special committee retained financial and legal advisors, the controller and target entered into a confidentiality agreement, and the controller's CEO and president met with the chairman of the target's special committee six times. The Court of Chancery, applying the plaintiff-friendly reasonable conceivability standard applicable to motions to dismiss, held that the *ab initio* requirement was not met because during those six meetings, the following back-and-forth occurred:

- The controller first proposed stock-for-stock consideration and an exchange ratio reflecting a discount to market price;
- The target responded by requesting a $4 special dividend and an exchange ratio not reflecting a discount;
- The controller proposed mixed consideration to accommodate a no-discount exchange ratio; and
- The target responded that the special committee would expect a cash-based premium.

The Court of Chancery reasoned that this colloquy was "substantive" under *Olenik* because it addressed the deal's "structure, exchange ratio, and price terms." The court cited the confidentiality agreement and the special committee's retention of advisers as further factual support for its holding.

The second case, *Salladay v. Lev*, 2020 WL 954032 (Del. Ch. Feb. 27, 2020), did not involve a controller, but rather a purportedly conflicted board's dealings with a strategic buyer in a third-party merger. After holding as a matter of first impression that the *ab initio* requirement applies to the use of non-*MFW* committees—that is, to instances where use of a special committee might reinstate the business judgment rule where entire fairness would otherwise apply due to board-level conflicts—the Court of Chancery found that the special committee had materialized too late to warrant a standard of review shift. Before the committee was formed, the target provided the acquirer with an initial overview of its business, the parties entered into a confidentiality agreement and began diligence, and a target director told the

acquirer that the target would be receptive to an offer in the range of $3.50 to $4 per share. The Court of Chancery concluded that the latter conversation gave rise to a pleading-stage inference that pre-committee substantive economic negotiations had occurred because it "set the stage for future economic negotiations" by creating a de facto price collar, as evidenced by the fact that the acquirer later opened its bid at $3.50 and the deal ultimately closed at $3.68. Put differently, these allegations created a reasonable inference that the special committee's work had been hamstrung by pre-committee dealings.

The third case, *In re Homefed Stockholder Litigation*, 2020 WL 3960335 (Del. Ch. July 13, 2020), involved, like *Alon*, a controller buyout. There, before agreeing to *MFW* protections, the controller engaged in discussions with a large blockholder that indicated it would support a transaction at a two-shares-for-one exchange ratio. The Court of Chancery concluded, again at the motion to dismiss stage, that these discussions violated the *ab initio* requirement because, as in *Salladay*, they anchored future price talks in a manner that undermined the special committee's ability to bargain effectively for the minority—to wit, the controller later cited the blockholder's support for the 2:1 exchange ratio in rebuffing a special committee counteroffer. The Court of Chancery further reasoned that, as a general matter, a controller's pre-*MFW* dealings with a blockholder offend *MFW*'s core policy purpose (protecting minority stockholders) because this practice would enable a controller to sidestep its need to deal with independent directors who, unlike stockholders, are uniquely qualified to advocate for the minority by virtue of their superior access to information and fiduciary obligation to act in the corporation's best interest.

These cases highlight a number of land mines transaction parties may wish to avoid while traversing the deal landscape. First, although the *ab initio* requirement obliges parties to avoid undertaking "substantive economic negotiations" before implementing *MFW* conditions, discussions leading to a one-sided indication of support for a given price by a minority stockholder (*Homefed*) or a range of prices by the target (*Salladay*) risk thwarting procedural protections' standard-shifting effect even absent the sort of back-and-forth typically imagined by the word "negotiation." While a price counteroffer is somewhat obviously out of bounds, less intuitive is the notion that parties should avoid revealing their own price preference (*Salladay*) or coaxing a price preference from a key blockholder (*Homefed*). In addition, the term "economic" envelops price terms aside from cash amounts, including share-for-share exchange ratios, whether the exchange ratio will reflect a discount to market price, and the appropriate mix of consideration (*Alon*). Further, although the above-referenced cases do not indicate that preliminary measures such as entry into a confidentiality agreement or a special committee's retention of advisors will violate the *ab initio* requirement per se, these measures may contribute to such a ruling (*Alon*). More generally, these cases suggest that in order to maximize the likelihood of satisfying *MFW*'s requirements, the dual *MFW* conditions should be in place as soon as possible and before entering into any material discussions about the transaction with the target or its directors or stockholders. Finally, fiduciaries undertaking a sale process should at all times remain mindful of the core objective informing the *ab initio* requirement's substance and purpose: timely erecting structural protections that effectively replicate the dynamics of an arm's-length transaction.

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