DELAWARE CORPORATE LAW BULLETIN

MFW's Ab Initio Requirement Not Satisfied When Controlling Stockholder Negotiated with Minority Stockholder Before Acceding to "[D]ual [P]rotections"

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In denying the defendants' motion to dismiss, Chancery Court finds that early stage negotiations with minority stockholder "ultimately dictated the final price" approved by special board committee

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INTRODUCTION

In *In re HomeFed Corp. S'holder Litig.*, No. 2019-0592-AGB, 2020 Del. Ch. LEXIS 235 (Del. Ch. July 13, 2020) ("*HomeFed*"), the Delaware Court of Chancery ("*Chancery Court*") denied pleading-stage dismissal of claims challenging a controlling stockholder-led buyout. In so ruling, Chancellor Andre G. Bouchard determined that the defendants—the controlling stockholder and members of the target company board of directors—were not entitled to the protection of the deferential business judgment rule despite purported compliance with the *MFW* Playbook developed by the Delaware Supreme Court in 2014.

I. LEGAL BACKGROUND

A. Evolution of MFW Playbook

Delaware courts traditionally examined controlling stockholder-led corporate buyouts under the exacting entire fairness standard of review. In such circumstances, the controlling stockholder bears the rigorous burden of demonstrating both fair dealing and fair price rather than being sheltered by the deferential business judgment rule. Pleading-stage dismissal generally was not available.

A sea change occurred with the Chancery Court's ruling in *In re MFW S'holders Litig.*, 67 A.3d 496 (Del. Ch. 2013), affirmed by the Delaware Supreme Court in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) (collectively, "*MFW*"). By virtue of *MFW*, transactions involving controlling stockholders may secure business judgment review, rather than having to establish entire fairness, by adhering to the six-prong test formulated in *MFW* (often referred to as the "*MFW Playbook*"):

> (i) [T]he 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 in negotiating

> a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.

The first prong of the *MFW* Playbook—approval by a special board committee and by a majority of the minority stockholders—has become known as the "[*D]ual [P]rotections*" (emphasis added). In so ruling, the *MFW* court "reasoned that the 'simultaneous deployment of [these] procedural protections . . . create a countervailing, offsetting influence of equal—if not greater—force' than the undermining influence of a controller." Put simply, the *MFW* protections seek to replicate the negotiating environment in an arm's-length transaction. Crucially, securing business judgment review facilitates pleading-stage dismissal of claims brought by unhappy minority stockholders against the controlling stockholder and members of the target company's board of directors.

The *MFW* court included an important caveat to securing business judgment review through implementation of the *MFW* Playbook: the transaction must be "conditioned *ab initio* upon both the approval of an independent, adequately-empowered Special [Board] Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders." This caveat is often referred to as the ab initio requirement. By committing to the Dual Protections ab initio, the "controller irrevocably and publicly disables itself from using its control to dictate the outcome of the negotiations" from the outset of the transaction.

B. Contours of the Ab Initio Requirement

The Delaware judiciary has shed light on the contours of the ab initio requirement. In *In re Books-A-Million, Inc. S'holders Litig.*, No. 11343-VCL, 2016 WL 5874974 (Del. Ch. Oct. 10, 2016) ("*BAM*"), after a controlling stockholder proposed a buyout of minority stockholders, the target board formed a special committee to evaluate the offer. The controlling stockholder withdrew its initial proposal but, over two years later, surfaced another offer with a different price and terms. Significantly, the new offer was conditioned on satisfaction of the Dual Protections. The *BAM* court ruled that the second offer was not a "continuation of" the earlier proposal, but rather, the beginning of a separate bargaining process. As such, implementation of the Dual Protections at the outset of the second offer satisfied the ab initio requirement, permitting business judgment review of the transaction. For a discussion of *BAM*, see Robert S. Reder, *Delaware Court Grants*

Pleading-Stage Dismissal of Litigation Challenging Control Stockholder-Led Buyout, 70 VAND. L. REV. EN BANC 217 (2017).

In *Flood v. Synutra Int'l, Inc.*, 195 A.3d 754 (Del. 2018) ("*Flood*"), the Delaware Supreme Court rejected a bright-line rule that a "controller must include the [Dual Protections] in its 'first offer' or else lose out on the business judgment rule" (quoting *Flood*). Rather, the Dual Protections must be announced "before any negotiations took place" (quoting *Flood*). The *Flood* court found that the ab initio requirement was satisfied—even though the first offer did not reference the Dual Protections—because the revised proposal containing the Dual Protections was delivered before the special committee held its first meeting, hired advisors, or actually negotiated the offer.

The next year, the Delaware Supreme Court refined its *Flood* analysis in *Olenik v. Lodzinski*, No. 392, 2018, 2019 WL 1497167 (Del. Apr. 5, 2019) ("*Olenik*"). In *Olenik*, the parties engaged in nine months of so-called "preliminary discussions" before the Dual Protections were included in a formal offer letter (quoting *Olenik* here and throughout the rest of this paragraph). Even though two months of substantive negotiations followed delivery of the offer letter, the *Olenik* court found "that the preliminary discussions transitioned to substantive economic negotiations" when, before delivery of the offer letter, the parties conducted a joint valuation exercise which effectively "set the field of play for the economic negotiations to come." Thus, the transaction did not satisfy the ab initio requirement. In this vein, the *Olenik* court highlighted the distinction between preliminary discussions, essentially "exploratory in nature," and substantive economic negotiations. The former, "never r[ising] to the level of bargaining," would not violate the ab initio requirement, though the latter would. For a discussion of *Flood* and *Olenik*, see Robert S. Reder, *Delaware Supreme Court Explores Application of* MFW*'s "*Ab Initio*" Requirement in Controlling Stockholder-Related Litigation*, 72 VAND. L. REV. EN BANC 237 (2019).

C. Stockholder Negotiations No Substitute for Active Committee

The Chancery Court also has considered whether the *MFW* Playbook is satisfied when a controlling stockholder negotiates with certain minority stockholders before obtaining special committee sign-off. In *In re Amtrust Fin. Servs.*, No. 2018-0396-AGB, 2020 WL 914563 (Del. Ch. Feb. 26, 2020) ("*AmTrust*"), a controlling stockholder negotiated with a large minority stockholder after he objected to a buyout originally negotiated with a special committee. These

negotiations resulted in improved terms which then were approved by the special committee. Plaintiffs argued that the negotiations with the minority stockholder disqualified reliance on *MFW*. Because another prong of the *MFW* Playbook was not satisfied, Chancellor Bouchard did not find it necessary to address this argument, but nevertheless offered that "Plaintiffs' argument seem[ed] to find support in [*Flood*]" (quoting *AmTrust*).

Vice Chancellor J. Travis Laster confronted this issue directly in *In re Dell Techs. Inc. Class V S'holders Litig.*, No. 2018-0816-JTL, 2020 WL 3096748 (Del. Ch. June 11, 2020) ("*Dell Technologies*"). According to the Vice Chancellor, the controlling stockholder "failed to respect the [Dual Protections] when it bypassed the Special Committee and negotiated directly" with a group of minority stockholders (quoting *Dell Technologies* here and throughout the rest of this paragraph). Once the target board delegated the "power and duty to protect the best interests of the minority stockholders" to a special committee, the Vice Chancellor opined that the committee "was not at liberty to become a passive instrumentality" that deferred to negotiations between the controller and certain minority stockholders. This was one of several failures to satisfy the *MFW* Playbook that led the Vice Chancellor to deny pleading-stage dismissal. For a discussion of *Dell Technologies*, see Robert S. Reder & Kirby W. Ammons, *Failure to Satisfy Four Prongs of* MFW *Framework Dooms Pleading-Stage Dismissal of Claims Arising from Controlling Stockholder-Led Redemption of Minority Shares*, 74 VAND. L. REV. EN BANC 47 (2021).

* * * * *

In *HomeFed*, Chancellor Bouchard faced a confluence of the issues raised in *Olenik* and *Dell Technologies*. According to the plaintiffs, a controlling stockholder violated the *MFW* Playbook when it engaged in price negotiations with a significant minority stockholder *before* agreeing to the Dual Protections. Because these "substantive economic discussions . . . anchored later negotiations and undermined the ability of the special committee to bargain effectively on behalf of the minority stockholders," Chancellor Bouchard found the plaintiffs' well-plead allegations sufficient to warrant denial of pleading-stage dismissal.

II. FACTUAL BACKGROUND

A. Jefferies Contemplates Buyout of Minority Stockholders

HomeFed Corporation (the "*Company*") is "engaged in the development and ownership of residential and mixed-use real estate projects." In September 2017, a member of the Company's seven-person board of directors ("*Board*") delivered a letter ("*September 2017 Letter*") to the Company's controlling stockholder, Jefferies Financial Group Inc. ("*Jefferies*"), proposing a transaction in which each Company share not owned by Jefferies would be converted into two Jefferies shares. As a result, the Company would become a wholly owned subsidiary of Jefferies. Based on Jefferies' then-current trading price, the 2:1 exchange ratio "implied a price of $50 per each [Company] share."

At that time, Jefferies, "a diversified holding company with an array of businesses and investments," owned "approximately 70% of the Company's common stock." Moreover, three Board members "held senior positions at Jefferies." Soon after receiving the September 2017 Letter, Jefferies approached Beck, Mack and Oliver, LLC ("*BMO*"), the Company's second largest stockholder with "approximately 36% of the shares unaffiliated with Jefferies," to gauge BMO's views on the proposed transaction. These discussions did not progress as BMO's "thoughts on an appropriate exchange ratio were very different from those of Jefferies."

In December, the Board established a special committee of two directors not affiliated with Jefferies ("*Special Committee*") with "the exclusive power and authority [ ] to review, evaluate and propose the terms and conditions, and determine the advisability of" any potential transaction, including with Jefferies. The Special Committee in turn retained legal counsel and sought advice from (but did not at the time formally engage) Houlihan Lokey ("*Houlihan*") as its financial advisor.

In March 2018, Jefferies signaled that it was no longer interested in a transaction. Because the Company's stock "was trading around $55 per share" while Jefferies' "was trading at around $24 per share," the proposed 2:1 exchange would have yielded "an approximately 13% negative premium for [Company] stockholders." In response, "the Special Committee determined to 'pause' its process of exploring a potential transaction."

B. Jefferies Negotiates the Buyout

Despite this "pause," over the next eleven months "Jefferies 'repeatedly' held discussions with BMO . . . about a potential" Jefferies buyout of the minority stockholders. Jefferies and BMO remained "far apart" until early February 2019, when BMO changed course and "encouraged" Jefferies to proceed with a 2:1 exchange offer.

In mid-February 2019, the Special Committee learned for the first time of Jefferies' negotiations with BMO. In an effort to maintain control, the Special Committee directed counsel to advise Jefferies of the impropriety of its discussions with BMO. After speaking with Jefferies, counsel reported back that not only was Jefferies inclined to proceed with the buyout, but both also BMO and another significant minority stockholder (later identified as RBC Capital Markets ("*RBC*") who, together with BMO, controlled 70% of the Company's minority shares) supported a 2:1 exchange ratio.

Then, on February 19, Jefferies publicly proposed a transaction offering a 2:1 exchange offer for all minority shares that was conditioned, notably, on satisfaction of the Dual Protections ("*February 2019 Offer*"). In March, after formally engaging Houlihan, the Special Committee directed Houlihan to canvas minority stockholders (including BMO and RBC). Houlihan reported back that stockholders generally found the price implied by the exchange ratio "inadequate," yet "superior to the status quo," and "begrudgingly" supported the buyout.

In late March, the Special Committee countered with "a $42 fixed value" proposal to Jefferies. Jefferies reached out to BMO and, rather than mentioning the Special Committee's counteroffer, framed its 2:1 exchange offer as "a 'take it or leave it' proposition." Again preferring a Jefferies buyout to the status quo, BMO expressed support. Citing its conversations with BMO, Jefferies formally rejected the Special Committee's counteroffer on March 27. Faced with this reality, the Special Committee accepted the February 2019 Offer. After a majority of the minority stockholders approved the transaction on June 28, the transaction was completed.

C. Litigation Ensues

In a matter of days, former minority stockholders ("*Plaintiffs*") challenged the transaction in Chancery Court, asserting breach of fiduciary duty on the part of both (i) Jefferies for, in its capacity as "controlling stockholder[,]" "devising and orchestrating 'the unfair and

self-dealing' " transaction, and (ii) the members of the Board for "agreeing to . . . 'unfairly low consideration.' " All defendants moved to dismiss, claiming their satisfaction of the *MFW* Playbook triggered business judgment review. Chancellor Bouchard, concluding that "Plaintiffs have plead a reasonably conceivable set of facts that Jefferies did not impose the *MFW* conditions *ab initio*," rejected the defendants' motion to dismiss.

III. CHANCELLOR BOUCHARD'S ANALYSIS

At the outset, Chancellor Bouchard explained that Plaintiffs, to avoid pleading-stage dismissal, must "plead a reasonably conceivable set of facts showing that any or all of those enumerated conditions [of the *MFW* Playbook] did not exist." To satisfy this burden, Plaintiffs claimed that "three of the six conditions required under *MFW* were not satisfied." The Chancellor focused on the Dual Protections and, in particular, the ab initio requirement.

A. Special Committee "Pause" Did Not Create Two Separate Processes

Plaintiffs contended that, for purposes of the ab initio requirement, the September 2017 Letter "led to a continuous series of substantive negotiations concerning a potential transaction . . . *before* [Jefferies] committed to the *MFW* framework." The defendants, relying on *BAM*, countered that the original discussions ceased in March 2018 "when Jefferies abandoned pursuit of a transaction" and that a "separate process" commenced with the February 2019 Offer, in connection with which Jefferies timely invoked the Dual Protections.

Chancellor Bouchard considered the defendants' reliance on *BAM* "misplaced." In *BAM*, the Chancellor noted that the proposal ultimately negotiated by the parties was made " 'nearly three years after' a special committee rejected an initial proposal from the controller containing 'a different price and different terms.' " By contrast, based on Plaintiffs' "well-plead allegations," the Chancellor found it "reasonably conceivable that the February 2019 Offer was part of the same process" triggered by the September 2017 Letter, despite the Special Committee's eleven-month "pause," rather than two discrete periods of negotiations.

B. Jefferies Negotiations with BMO Doom MFW Defense

"[U]ltimately," Chancellor Bouchard explained, it "makes no difference" whether the negotiations triggered by the February 2019

Offer "w[ere] part of the process" commenced by the September 2017 Letter or "triggered a new process." What actually doomed the defendants' *MFW* defense was that, "in either case, Jefferies did not commit to the *MFW* protections before engaging in substantive economic discussions" with BMO. These discussions led to receipt of "an indication of support for a 2:1 share exchange from BMO—whose support was essential to get a deal done with minority stockholder approval—as well as from RBC *before* Jefferies agreed to the dual *MFW* protections." Accordingly, Jefferies' discussions with BMO preceding the February 2019 Offer violated the ab initio requirement.

In so ruling, the Chancellor found no "merit" in the defendants' argument that Jefferies' pre-February 2019 Offer discussions with BMO "did not pass the point of no return for invoking *MFW*'s protections," but rather, were " 'preliminary' and only involved 'an unaffiliated minority stockholder with no ability or authority to bind the corporation or any other stockholder.' " According to Chancellor Bouchard,

- Plaintiffs "sufficiently allege[ ] that, by engaging in substantive economic discussions with BMO before committing itself to the twin MFW protections, Jefferies failed to disable and subject itself to the pressures of negotiating with the Special Committee with those protections in place." "To that end . . . Jefferies cited BMO's support for a 2:1 exchange ratio when it rebuffed the Special Committee's $42 fixed value counteroffer."
- Rather than being "preliminary," as the defendants argued, Jefferies' discussions with BMO "concerned the key economic term of the Transaction—the price," particularly given that BMO's support for the 2:1 exchange ratio "ultimately dictated the final price."
- Echoing Dell Technologies, the defendants' attempt to distinguish substantive negotiations with a Company stockholder (BMO) from those with the Special Committee was unavailing:

> To my mind, it would be imprudent to endorse a rule that would allow a controller to undermine the effectiveness of a special committee preemptively through direct negotiations with a stockholder under the circumstances plead here as much as it would be to do so after the committee has been authorized formally.

CONCLUSION

As *HomeFed* demonstrates, the Chancery Court continues to refine the *MFW* Playbook to ensure the policy underlying its formulation is honored:

- Under Olenik, and consistent with the ab initio requirement, a controlling stockholder must invoke the Dual Protections before commencement of substantive economic negotiations with a special board committee.
- Under Dell Technologies, even after the Dual Protections have been invoked, a special board committee may not adopt a passive approach that allows the controlling stockholder to negotiate the terms of the buyout with minority stockholders.
- And, under HomeFed, if a controlling stockholder intends to invoke the favorable standard of review offered by MFW, the controller may not engage in substantive economic negotiations with a minority stockholder before the Dual Protections are invoked.

MFW affords controlling stockholders a powerful shield to avoid the heavy burden of proof imposed by the entire fairness standard of review. But to win pleading-stage dismissal, a controlling stockholder must scrupulously adhere to the *MFW* Playbook, including the ab initio requirement. Moreover, it is crucial for legal advisors not only to keep abreast of developments in the Delaware courts' approach to *MFW*, but also to convince their controlling stockholder clients not to use their considerable leverage to take disqualifying shortcuts or to abide by *MFW*'s procedural requirements in name only. The Chancery Court has demonstrated its disinclination to overlook deviations from the *MFW* Playbook.