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From the Get-Go: Interpreting *MFW*'s *Ab Initio* Requirement

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The Delaware Supreme Court's seminal decision in *Kahn v. M&F Worldwide Corporation* (*MFW*) offers a pathway for having challenges to controlling stockholder "squeeze-out" mergers reviewed under the highly deferential business judgment rule rather than Delaware's most onerous standard of review, entire fairness.[1] According to the Supreme Court, "[T]he business judgment standard of review will be applied *if and only 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 in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority."

Although the Supreme Court set forth six requirements, courts and practitioners often condense the rule to its two core principles, or "dual procedural protections" — namely, that the transaction must be approved by (i) an empowered, independent special committee and (ii) a fully informed, uncoerced majority of the minority vote. In *MFW*, the Supreme Court instructed that a transaction must be conditioned on these dual protections *ab initio*, *i.e.*, "from inception" or before "procession of the transaction." The court reasoned that the *ab initio* requirement is necessary because it forces the controlling stockholder to acknowledge from the outset "that it cannot bypass the special committee's ability to say no," and that "it cannot dangle a majority-of-the-minority vote before the special committee late in the process as a deal-closer rather than having to make a price move."

Recently, the Delaware Supreme Court and the Court of Chancery have had the opportunity to further develop the *ab initio* requirement.

Discussions vs. Negotiations

In October 2018, the Supreme Court opined on the *ab initio* requirement for the first time since *MFW* in *Flood v. Synutra International, Inc.*[2] In the Court of Chancery, the stockholder plaintiff argued that *MFW* did not apply to a squeeze-out merger because the control group's initial nonbinding proposal "did not condition a potential transaction on both a favorable committee recommendation and approval by a majority of the disinterested stockholders." The control group did, however, send a follow-up letter two weeks after its initial proposal in which it "expressly conditioned the transaction on the approval of the Special Committee and a majority of the minority stockholders." The trial court applied *MFW*, explaining that "[a] process meets the *ab initio* requirement when the controller announces the conditions 'before any negotiations took place.'" It then observed that "[t]he only arguably substantive event that happened before the Follow-up Letter" was that the target company's CFO authorized the company's primary outside counsel to represent the control group by waiving any conflict that the outside counsel might have. In rejecting the plaintiff's challenge to the *ab initio* requirement, the court noted that "[t]he prompt sending of the Follow-up Letter prevented the [control group] from using the [*MFW*] conditions as bargaining chips." The Court of Chancery thus held that "[t]he plaintiff has not pled facts sufficient to call into question compliance with the *ab initio* requirement."

The Supreme Court affirmed the Court of Chancery's decision. It explained that *MFW*'s *ab initio* requirement was satisfied because the "required preconditions were ... in place before any economic negotiation between the Special Committee and the controller occurred." The Supreme Court further explained that *MFW*'s *ab initio* requirement recognized that under prior doctrine, controllers had little incentive to condition approval

[1] 88 A.3d 635 (Del. 2014).

[2] No. 101, 2018 (Del. Oct. 9, 2018).

on a majority-of-the-minority vote at the outset and often times used a minority vote at the end of negotiations as a bargaining chip in lieu of a price bump. Under that circumstance, "those subject to the economic consequences of the process — the minority stockholders — were left either without a say or with a say at the potential expense of additional consideration that might have been extracted by tougher economic bargaining." Thus, "[t]he essential element of *MFW*, then, is that the [minority vote condition] cannot be dangled in front of the Special Committee, when negotiations to obtain a better price from the controller have commenced, as a substitution for a bare-knuckled contest over price." In other words, *MFW* requires a "controller to self-disable before the start of substantive economic negotiations."

Shortly before the Supreme Court issued its decision in *Flood*, the Court of Chancery addressed the difference between discussions and negotiations in *Olenik v. Lodzinski*.[3] The case involved an "Up-C" transaction, whereby two companies with the same controller entered into a stock-for-stock merger. The acquiring company's stockholders, who ended up with a minority interest in the resulting company, filed suit alleging that the controller and others had breached their fiduciary duties by using the merger as a bailout of their investments in the acquired company. They argued that *MFW* did not apply because, among other things, the controller did not condition the deal upon satisfaction of the dual procedural protections until after 10 months of "extensive" premerger discussions had occurred.

Despite those "extensive" discussions, the Court of Chancery held that the *ab initio* requirement was satisfied because the acquirer's first offer letter — the starting point of "negotiations" — expressly conditioned the deal on approval of both a special committee of independent directors and a majority vote of the acquirer's stockholders unaffiliated with the controller. In drawing a distinction between "discussions" and "negotiations," the court noted that "for purposes of the *MFW* analysis, in most instances, 'negotiations' begin 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."

Third-Party Transactions

In 2017, the Court of Chancery addressed the applicability of the *MFW* framework in a unique setting — third-party transactions where the controller receives a non-ratable benefit. The case, *In re Martha Stewart Living Omnimedia, Inc. Stockholder Litigation*,[4] involved a merger where Sequential Brands Group acquired Martha Stewart Living Omnimedia (MSLO). The MSLO board established an independent special committee in 2014 with full authority to evaluate and recommend strategic transactions. In the spring of 2015, Sequential emerged as a possible buyer after having been spurned by MLSO six months earlier. Sequential did not mention a majority-of-the-minority vote in its initial proposal, but three weeks later sent a revised proposal, conditioning procession of the deal on the minority's approval. MSLO received the revised proposal before Sequential approached the special committee about negotiating separately with Stewart regarding her employment and intellectual property agreements, which were material benefits she alone would receive in the transaction.

After the merger was announced, minority stockholder plaintiffs filed suit alleging that Martha Stewart was MSLO's controlling stockholder and that she extracted non-ratable "side deals" in the form of the employment and intellectual property agreements. They argued that the transaction did not satisfy *MFW*'s *ab initio* requirement because Sequential did not condition procession of the deal on a majority-of-the-minority vote until well after it began negotiating with MSLO. The Court of Chancery disagreed. The court framed the question as, "[A]t what point must the parties to a potentially conflicted third-party transaction involving a controlling stockholder agree to the dual procedural protections in order for the controller to earn pleadings-stage business judgment deference?" The court stated the

[3] C.A. No. 2017-0414-JRS (Del. Ch. July 20, 2018).

[4] Consol. C.A. No. 11202-VCS (Del. Ch. Aug. 18, 2017).

plaintiffs' argument that the procedural protections must be in place at the outset of discussions between the target and the third party "would make no sense." Instead, the court held the *ab initio* requirement will be satisfied in a third-party transaction if the dual procedural protections are in place at "the point where the controlling stockholder actually sits down with an acquiror to negotiate for additional consideration." Ultimately, the Court of Chancery found that the transaction satisfied the *ab initio* requirement because both the independent special committee and the majority-of-the-minority vote were in place at the time Stewart began negotiating with Sequential.

Terminating Negotiations

In 2016, the Court of Chancery held that a controller can regain business judgment rule protection if an offer that does not comply with *MFW* is terminated and negotiations later begin anew and are conditioned on compliance with *MFW*. In *In re Books-A-Million, Inc. Stockholders Litigation*,[5] plaintiff stockholders argued that the *ab initio* requirement was not satisfied because the controllers' 2015 proposal to acquire Books-A-Million, which was conditioned from the outset on *MFW*'s dual protections, was a continuation of a prior, rejected proposal from 2012, "which did not have the twin conditions necessary for the [*MFW*] framework." Relying on contract law, the court held that was "not a reasonably conceivable inference" because the plaintiffs had acknowledged that "a special committee rejected the 2012 offer, thereby terminating it." The court went on to explain that "[t]he 2015 offer came nearly three years after the 2012 offer and contained a different price and different terms. The 2015 proposal was a different offer, and it generated a separate process." The court, therefore, held that the deal satisfied the *ab initio* requirement and dismissed the complaint.

[5] Consol. C.A. No. 11343-VCL (Del. Ch. Oct. 10, 2016).

Takeaways

Although perhaps straightforward in concept, the *ab initio* requirement has been the subject of judicial refinement in the four years that have followed the *MFW* decision. Recent decisions from the Delaware Supreme Court and Court of Chancery construing the *ab initio* requirement offer guidance for structuring controlling stockholder transactions in the future. These decisions teach that in certain circumstances:

- *MFW*'s dual protections may be established after initial discussions have occurred, as long as a potential transaction is expressly conditioned on the dual protections before economic negotiations begin.
- Third-party transactions where the controlling stockholder receives a material benefit that is not shared with the minority may receive business judgment rule review if the dual protections are in place before the controller begins negotiating with the third party.
- Once noncompliant negotiations are terminated, the controlling stockholder may get a fresh start by conditioning a new round of negotiations on the dual protections.