

Chancery Court applies *MFW* framework in private equity merger transaction

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Introduction

In *Olenik v Lodzinski*,⁽¹⁾ Vice Chancellor Slight applied the framework established by the Delaware Supreme Court in *Kahn v M&F Worldwide Corp (MFW)*, finding that a merger transaction with a controlling private equity fund on both sides was entitled to business judgment review. The decision helpfully outlines the elements of the *MFW* roadmap and clarifies that its *ab initio* requirement requires only that the *MFW* elements be in place prior to the commencement of negotiations that, if accepted, would yield an agreement of the parties.

Facts

The private equity fund EnCap Investments, LP owned two portfolio companies, Earthstone Energy, Inc and Bold Energy. EnCap believed that Bold might be an attractive acquisition target for Earthstone, so EnCap provided Earthstone with diligence materials concerning Bold. The management representatives for Earthstone, Bold and EnCap then met to discuss a potential transaction. After the meeting, Earthstone's board formed a special committee consisting of two independent directors, which submitted a formal offer letter to acquire Bold that expressly conditioned the offer on the final approval of the special committee and approval of a majority of Earthstone's stockholders that were not affiliated with EnCap.

The negotiations continued and Bold and Earthstone ultimately entered into a transaction that was overwhelmingly approved by the disinterested stockholders. Nonetheless, the transaction was challenged in a derivative suit brought against Earthstone and the members of its board of directors, where the plaintiffs alleged breach of fiduciary duty and related aiding and abetting claims.

In *MFW*, the Delaware Supreme Court held that a court will review a merger transaction involving a controlling stockholder under the more lenient business judgment rule if the proposed transaction is expressly conditioned, *ab initio*, on the informed approval of:

- a fully empowered independent committee that has properly exercised its duty of care; and
- a majority of the minority stockholders who are free of coercion.

MFW rejects the argument that all controlling stockholder transactions are conflicted and instead provides a framework that, when followed, "mimic[s] arm's-length dealings" and avoids the conflicts of interests that necessitate fact-intensive entire fairness review.

Decision

In *Olenik v Lodzinski*, the plaintiffs argued that the *ab initio MFW* condition was not satisfied because the deal discussions began before Earthstone had empowered a special committee and conditioned the deal on an informed vote of the special committee and disinterested stockholders. The court rejected this argument and concluded that the preliminary discussions prior to the offer letter "never rose to the level of bargaining" and were "entirely exploratory in nature". The court emphasised the distinction between discussions regarding the possibility of a deal and negotiations of a proposed transaction. The court held that 'negotiations' take place only 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". As such, because Earthstone's offer letter marked the beginning of negotiations between the parties, the inclusion in the offer letter of the express conditions of *MFW* satisfied the *ab initio* condition.

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The plaintiffs further contended that the participation of Earthstone's chief executive officer and chair – who had ties to the special committee members – in negotiations with Bold demonstrated that the special committee was not independent, well-functioning and fully empowered. The court rejected this argument and held that without allegations of materiality, mere social and financial ties between the independent directors and the counterparty did not give a basis for the plaintiffs' claim. In sum, the court found that the "telltale signs of a well-functioning special committee— independence, full and unfettered negotiating authority and careful deliberation—[were] all present" and that the committee had satisfied its duty of care such that the plaintiffs could not plead gross negligence.

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Endnotes

(1) *Olenik v Lodzinski*, CA 2017-0414-JRS (Del Ch 20 July 2017).

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