Clients&FriendsMemo

Delaware Court of Chancery Further Clarifies the "*Ab Initio*" Requirement in Finding That Discussions Between the Controlling Stockholder and a Minority Stockholder Precluded the Application of *MFW*

August 24, 2020

In *In re HomeFed Corp. Stockholder Litigation* ("*HomeFed*"),[1] the Delaware Court of Chancery considered on a motion to dismiss whether a squeeze-out merger by a controlling stockholder complied with the procedural framework set forth in *Kahn v. M&F Worldwide Corp.* ("*MFW*").[2] In *MFW*, the Delaware Supreme Court held that the business judgment rule—rather than the entire fairness standard—applies to a controlling stockholder transaction if the transaction is conditioned "*ab initio*," or at the beginning, upon approval of both an independent special committee of directors and the informed vote of a majority of the minority stockholders.[3]

In *HomeFed*, however, the court denied a motion to dismiss by the defendants, the directors of HomeFed Corporation ("HomeFed") and its controller Jeffries Financial Group, Inc. ("Jeffries"), crediting allegations that Jeffries did not commit to the dual *MFW* protections before commencing discussions with HomeFed's largest minority stockholder.[4] In addition, the court found that a one-year "pause" in negotiations between Jeffries and HomeFed's special committee did not "reset" the *ab initio* requirement of *MFW*.[5]

The court also considered the disinterestedness of two directors who voted to approve the transaction with Jeffries. Despite an exculpatory provision in HomeFed's certificate of incorporation,

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1 No. 2019-0592-ABG, 2020 WL 3960335 (Del. Ch. July 13, 2020).

2 88 A.3d 635 (Del. 2014).

3 *Id.* at 644; *see also* Joshua Apfelroth *et al.*, *M&A Update: Delaware Supreme Court Clarifies the "Ab Initio" Requirement for Business Judgment Review of Controlling Stockholder Transactions in Flood v. Synutra*, Cadwalader, Wickersham & Taft LLP (Nov. 2, 2018), https://www.cadwalader.com/resources/clients-friends-memos/ma-update-delaware-supreme-court-clarifies-the-ab-initio-requirement-for-business-judgment-review-of-controlling-stockholder-transactions-in-flood-v-synutra.

4 *HomeFed*, 2020 WL 3690335, at *1.

5 *Id.* at *9-10.

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the court credited allegations that the directors lacked independence, including due to a consulting arrangement with Jeffries and past executive roles with Jeffries.[6]

HomeFed serves as an important reminder of the limits of the protections that *MFW* offers against challenges to controller transactions. Critically, controlling stockholders must implement the dual protective devices of *MFW* at the initiation of substantive economic negotiations with a special committee or minority stockholders.

Background

In 2017, an independent HomeFed director proposed a transaction to the Chairman of Jeffries' board of directors (and also a member of HomeFed's board) in which Jeffries would take HomeFed private by acquiring the outstanding shares in a 2:1 share exchange (two shares of Jeffries' stock for every HomeFed share by minority stockholders).[7] At that time, Jeffries owned 70% of HomeFed's common stock and had three members of HomeFed's seven-member board.

In December 2017, the HomeFed board created a special committee consisting of the two independent directors to investigate a potential stock transaction with Jeffries.[8] The board further resolved that management should not engage in any negotiations with any party to a potential transaction without approval by the special committee.[9]

Shortly thereafter, the special committee was informed that Jeffries no longer wanted to pursue the transaction, and the special committee "paused" the process of exploring the transaction in March 2018.[10] Notwithstanding the "pause," however, Jeffries proceeded to engage in discussions with Beck, Mack and Oliver, LLC ("BMO"), the second largest stockholder and owner of approximately 36% of the shares unaffiliated with Jeffries.[11]

After nearly a year of discussions, BMO encouraged Jeffries to make a proposal to acquire all of the outstanding shares of HomeFed common stock at an exchange ratio of 2:1, as originally proposed

6 *HomeFed*, 2020 WL 3690335, at *12.

7 *Id.* at *3.

8 *Id.*

9 *Id.*

10 *Id.* at *4.

11 *Id.* at *3-4.

in 2017.[12] BMO further indicated that RBC Capital Markets ("RBC"), another minority owner of HomeFed shares, would also support the transaction.[13]

On February 19, 2019, Jeffries announced a proposal to acquire the remaining HomeFed common stock, including "a condition that the proposed transaction will require the approval of a majority of the outstanding shares of [HomeFed]'s Common Stock not already owned by Jefferies (or its affiliates)" and that "[i]t is anticipated that the proposed transaction will be considered by a Special Committee of the Company's Board of Directors, comprised of Independent Directors of the Company's Board, whose affirmative recommendation to the Company's Board of Directors will be required under the . . . Stockholders Agreement."[14]

After Jeffries' announcement, the board reauthorized the special committee (which had never been dissolved) to consider a transaction with Jeffries.[15] Additionally, Jeffries agreed that it would not have substantial communications with other shareholders without the permission of the special committee.[16]

The special committee proposed a $42 fixed value transaction to Jeffries.[17] Jeffries discussed HomeFed's counteroffer with BMO, and rejected it in favor of its original offer for a 2:1 exchange ratio, citing BMO's support for this proposed transaction.[18]

On April 2, 2019, the special committee agreed to the proposed 2:1 exchange ratio with the condition of a proposed collar with a bottom threshold of $38 and high threshold of $42.[19] Jeffries agreed to this structure and entered into a merger agreement with HomeFed.[20]

Following the public announcement of the transaction, BMO and RBC objected to the high collar of $42, leading to the agreed withdrawal of both the high and low collars.[21]

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[12] *Id.*

[13] *Id.*

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] *Id.*

[18] *Id.*

[19] *Id.* at *7.

[20] *Id.*

[21] *Id.*

After the minority stockholders subsequently approved the transaction on June 28, 2019, plaintiffs sued and asserted two claims: (1) breach of fiduciary duty against the seven HomeFed directors; and (2) breach of fiduciary duty against Jeffries as controlling stockholder.[22] The Delaware Court of Chancery denied defendants' motion to dismiss and permitted the case to proceed to discovery.

Takeaways

1. To avail itself of a business judgment review, a controlling stockholder must ensure that the dual protective devices of *MFW* are in place from the start of any substantive negotiations. In applying the Delaware Supreme Court's decision in *MFW*, the Court of Chancery reiterated that a merger must be "conditioned *ab initio* upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders."[23] The court emphasized that the purpose of these conditions is to disable the controller from exerting its control to dictate the outcome of negotiations.[24] If a controlling stockholder does not establish the two conditions before the initiation of substantive negotiations, the proposed transaction will be subject to the entire fairness standard of review—not the less burdensome business judgment review.[25]

   Here, plaintiffs sufficiently alleged that Jeffries engaged in substantive economic discussions with BMO prior to committing to the *MFW* protections.[26] In rejecting Jeffries' argument that its discussions with BMO were merely "preliminary" discussions, the court observed that the discussions concerned "the key economic term of the transaction—the price."[27] According to the court, Jefferies "anchored the negotiations and undermined the Special Committee's ability to bargain effectively as the minority stockholders' agent." The court also noted that the price discussed with BMO before committing to the *MFW* framework "ultimately dictated the final price HomeFed's minority stockholders received for their shares in the Transaction a few months later." Thus, parties should be aware that discussions that concern the price – whether with a minority stockholder or the special committee – that occur prior to a commitment to the *MFW* framework may fatally undermine a pleading stage dismissal.

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[22] *Id.*

[23] *Id.* (citing *MFW*, 88 A.3d at 644).

[24] *Id.*

[25] *Id.* at *8-9.

[26] *Id.*

[27] *Id.* at *12.

2. In determining whether the *MFW* conditions were in place "*ab initio*," negotiations may be deemed to begin with the first substantive discussion, notwithstanding a lengthy "pause" for a special committee. The court rejected defendants' argument that the dual protective devices imposed by Jeffries in the February 2019 offer satisfied the *MFW* requirements because, according to the court, the initial substantive negotiations began in December 2017.[28] The court was unpersuaded by the defendants' contention that the special committee's "pause" somehow reset the process, noting that: (1) the special committee was never dissolved; (2) the initial resolutions were not repealed; (3) Jeffries continued to discuss the potential transaction over the next 11 months with BMO; and (4) the negotiations ultimately culminated in essentially the same offer and structure that was considered in 2017.[29] Thus, despite the lengthy pause in negotiations between the controlling stockholder, Jeffries, and the target company, HomeFed, the court found it conceivable that the negotiations and offer were part of the same process initiated in 2017. Therefore, the defendants could not avail themselves of the deferential business judgment rule.

3. The protective devices of *MFW* must be in place before the controlling stockholder engages in *any* substantial economic discussions, including discussions with a minority stockholder lacking the authority to bind the company to a transaction. The court held that even if Jeffries' offer was part of a new process of negotiations, Jeffries still did not satisfy the "*ab initio"* requirement because it engaged in substantive economic discussions with BMO before its commitment to the dual protective devices.[30]

   The court rejected Jeffries' argument that its discussions with BMO should not preclude dismissal under *MFW* because BMO, a minority stockholder, lacked authority to bind the company to a transaction.[31] The court noted that this issue—controller discussions with a minority stockholder before implementing the *MFW* protections—appeared to be a matter of first impression.[32] Relying on the "animating principle of *MFW*," the court explained that a controller must first self-disable and initiate negotiations with an independent and adequately empowered special committee.[33] According to the court, it would be "imprudent" to "allow a controller to undermine the effectiveness of a special committee

[28] *Id.* at *9.

[29] *Id.* at *10.

[30] *Id.*

[31] *Id.*

[32] The court distinguished the case from *In re Dell Technologies Inc. Class V Stockholders Litigation* where the controller bypassed the special committee in favor of direct negotiations with stockholders *after* invoking MFW's protections. *Id.*; *In re Dell Techns. Inc. Class V Stockholders Litig.*, No. 2018-0816-JTL, 2020 WL 3096748, at *19-20 (Del. Ch. June 11, 2020).

[33] *Id.*

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."[34] Thus, a controlling stockholder that wishes to invoke *MFW* should take care to avoid substantive negotiations with minority stockholders before committing to MFW's dual protections.

4. An exculpatory provision does not shield interested directors from liability. The court held that plaintiffs alleged sufficient facts to overcome the HomeFed directors' defense based on an exculpatory provision in HomeFed's certificate of incorporation.[35] Under *In re Cornerstone Therapeutics Inc. Stockholder Litigation*, a director is shielded from liability by an exculpatory provision *unless* a plaintiff pleads "facts supporting a rational inference that the director harbored self-interest adverse to the stockholders' interests, acted to advance the self-interest of an interested party from whom they could not be presumed to act independently, or acted in bad faith."[36] Here, plaintiffs demonstrated the directors' interest in the transaction by alleging numerous connections to Jeffries, including their roles as a consultant to Jeffries and executive officer of HomeFed.[37] Based on these allegations, the court found that the complaint adequately alleged that the directors acted to advance the self-interest of Jeffries when voting to approve the transaction because they lacked independence from Jeffries.[38]

Please click here for the full opinion.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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[34] *Id.*

[35] *Id.* at *12-13.

[36] *Id.* (quoting *In re Cornerstone Therapeutics Inc. Stockholder Litig.*, 115 A.3d 1173, 1179-80 (Del. 2015)).

[37] *Id.* at *13. The court noted that the Court of Chancery had previously held that a "consulting agreement suggests a lack of independence." *Id.* (citing *Orman v. Cullman*, 794 A.2d 5, 30 (Del. Ch. 2002)). The court further explained that a senior executive "generally lack[s] independence for purpose of evaluating matters that implicate the interests of a controller." *Id.* (quoting *In re Excorp Inc. Consulting Agreement Deriv. Litig.*, 2016 WL 301245, at *35 (Del. Ch. Jan. 25, 2016)).

[38] *Id.* at *13-14.

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