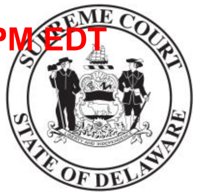
EFiled: Sep 28 2018 02:21PM EDT
Filing ID 62500986
Case Number 392,2018



IN THE SUPREME COURT OF THE STATE OF DELAWARE

NICHOLAS OLENIK, Individually and on Behalf of All Others Similarly Situated, Plaintiff-Below, Appellant, v. FRANK A. LODZINSKI, RAY SINGLETON, DOUGLAS E. SWANSON, BRAD THIELEMANN, ROBERT L. ZORICH, JAY F. JOLIAT, ZACHARY G. URBAN, ENCAP INVESTMENTS L.P., BOLD ENERGY III LLC, BOLD ENERGY HOLDINGS LLC and OAK VALLEY RESOURCES, LLC, Defendants-Below, Appellees, and EARTHSTONE ENERGY, INC, a Delaware corporation, Nominal Defendant-Below, Appellee.	No. 392, 2018 Court Below: Court of Chancery of the State of Delaware C.A. No. 2017-0414-JRS **Public Unredacted Version Filed September 28, 2018**

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Public Unredacted Version Filed
September 28, 2018

TABLE OF CONTENTS

TABLE OF AUTHORITIES iv

NATURE OF PROCEEDINGS 1

SUMMARY OF ARGUMENT 5

STATEMENT OF FACTS 9

A. Background Of Earthstone, EnCap And Oak Valley 9

B. Bold Faces A Liquidity Crisis 10

C. Lodzinski And EnCap Engage For Months Regarding A Bailout Of Bold By Earthstone 11

D. Lodzinski Belatedly Informs The Board That He, On Behalf Of Earthstone, "Intend[s] To Make An Offer" For Bold 13

E. The Board Sits Idly By And Permits Lodzinski To Negotiate An Earthstone/Bold Transaction 13

F. The Board Belatedly Forms A Special Committee, Which Allows Lodzinski To Steer Earthstone Into The Transaction Despite Myriad Red Flags 14

G. The Special Committee Acquiesces To The Transaction 16

H. The Board Omits Material Information From The Proxy 18

ARGUMENT 19

I. THE TRIAL COURT ERRED IN FINDING THAT THE TRANSACTION SATISFIED *MFW*'S *AB INITIO* REQUIREMENT 19

A. Question Presented 19

B. Scope of Review 20

C. Merits of the Argument 20

1. *MFW* Protections Were Not in Place *Ab Initio* 20

(a) The Trial Court Erred In Holding That The *MFW* Conditions Needed To Be In Place Merely By The Time Of The First Legally Binding Offer 21

(b) The Trial Court Erred By Failing To Draw Reasonable Inferences That Bargaining Or Negotiations Occurred Before The August 19 Letter 24

2. The August 19 Letter Does Not Satisfy *MFW*..........................28

(a) The Letter Does Not Reflect An Agreement By EnCap To The *MFW* Protections 28

(b) The Trial Court Erred By Considering The August 19 Letter On The Motions to Dismiss 31

II. THE TRIAL COURT ERRED IN FINDING THAT THE SPECIAL COMMITTEE ACTED WITH DUE CARE..34

A. Question Presented 34

B. Scope of Review..34

C. Merits of Argument 34

III. THE TRIAL COURT ERRED IN FINDING THAT THE STOCKHOLDER VOTE WAS FULLY INFORMED 40

A. Question Presented 40

B. Scope of Review..40

C. Merits of Argument 40

1. Applicable Materiality Standard 40

2. The Trial Court Erroneously Failed To Find Material That Stephens's Analysis Did Not Support The Transaction, So The Committee Directed Stephens To

Revise The Analysis Despite Knowing That The Revision Would Compromise The Results 42

3. The Trial Court Erroneously Failed To Find Material EnCap's Motivation For Orchestrating The Transaction 46

CONCLUSION 50

Exhibit A: Memorandum Opinion, decided July 20, 2018

TABLE OF AUTHORITIES

Cases **Page(s)**

Allen v. Encore Energy P'rs, L.P.,
72 A.3d 93 (Del. 2013) 32

Appel v. Berkman,
180 A.3d 1055 (Del. 2018) 8, 31, 40, 47

In re Books-A-Million S'holders Litig.,
2016 WL 5874974 (Del. Ch. Oct. 10, 2016) 22, 24, 30, 31

Branson v. Exide Elecs. Corp.,
645 A.2d 568 (Del. 1994) (TABLE) 41, 45

Brinckerhoff v. Enbridge Energy Co.,
159 A.3d 242 (Del. 2017) 20, 34, 40

Cent. Mortg. Co. v. Morgan Stanley Mortg. Capital Hldgs. LLC,
27 A.3d 531 (Del. 2011) 6, 25, 26, 30

Corwin v. KKR Fin. Hldgs. LLC,
124 A.3d 304 (Del. 2015) 42

In re Cox Commc'ns, Inc. S'holder Litig.,
879 A.2d 604 (Del. Ch. 2005) 22

Crescent/Mach I P'rs, L.P. v. Turner,
846 A.2d 963 (Del. Ch. 2000) 38

e4e, Inc. v. Sircar,
2003 WL 22455847 (Del. Ch. Oct. 9, 2003) 32

Eisenberg v. Chi. Milwaukee Corp.,
537 A.2d 1051 (Del. Ch. 1987) 47

Empls. Ret. Sys. of St. Louis v. TC Pipelines GP, Inc.,
152 A.3d 1248 (Del. 2016) (TABLE) 34

In re Ezcorp Inc. Consulting Agreement Deriv. Litig.,
2016 WL 301245 (Del. Ch. Jan. 25, 2016)...29

In re Gardner Denver, Inc. S'holders Litig.,
2014 WL 715705 (Del. Ch. Feb. 21, 2014) 31

Gerber v. EPE Hldgs., LLC,
2013 WL 209658 (Del. Ch. Jan. 18, 2013) 32

In re Jefferies Grp., Inc. S'holders Litig.,
C.A. No. 8059-CS (Del. Ch. Nov. 4, 2013) (TRANSCRIPT) 38, 39

Kahn v. M&F Worldwide Corp.,
88 A.3d 635 (Del. 2014) .... *passim*

Kahn v. Tremont Corp.,
694 A.2d 422 (Del. 1997) 37

Loudon v. Archer-Daniels-Midland Co.,
700 A.2d 135 (Del. 1997) 41

McPadden v. Sidhu,
964 A.2d 1262 (Del. Ch. 2008) 37

In re MFW S'holders Litig.,
67 A.3d 496 (Del. Ch. 2013) 22, 34

Morrison v. Berry,
2018 WL 3339992 (Del. July 9, 2018), *revised* July 27, 2018 47

NACCO Indus., Inc. v. Applica Inc.,
997 A.2d 1 (Del. Ch. 2009) 33

In re Orchard Enters., Inc. S'holder Litig.,
88 A.3d 1 (Del. Ch. 2014) 43

RBC Capital Mkts., LLC v. Jervis,
129 A.3d 816 (Del. 2015) 41

In re Rural Metro Corp. S'holders Litig.,
88 A.3d 54 (Del. Ch. 2014) 43, 44

Sandys v. Pincus,
152 A.3d 124 (Del. 2016) 25

Sherwood v. Ngon,
2011 WL 6355209 (Del. Ch. Dec. 20, 2011) 46

In re Synutra Int'l, Inc.,
2018 WL 705702 (Del. Ch. Feb. 2, 2018) 22

In re Tyson Foods, Inc. Consol. S'holder Litig.,
919 A.2d 563 (Del. Ch. 2007) 33

Weinberger v. UOP, Inc.,
457 A.2d 701 (Del. 1983) 36

Yiannatsis v. Stephanis ex rel. Sterianou,
653 A.2d 275 (Del. 1995) 42

Zirn v. VLI Corp.,
681 A.2d 1050 (Del. 1996) 44

Statutes

8 *Del. C.* § 220 1

Rules

Ct. Ch. R. 12(b)(6) 4, 20, 34, 40

Other Authorities

Restatement (Second) of Contracts § 39 (1981)...29

NATURE OF PROCEEDINGS

This appeal arises from a fundamental misapplication of this Court's decision in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) ("*MFW*"). Following a books and records investigation under 8 *Del. C.* § 220 ("220"), Plaintiff Nicholas Olenik ("Plaintiff"), a stockholder of Earthstone Energy, Inc. ("Earthstone" or the "Company"), filed an action (the "Action") in the Delaware Court of Chancery challenging a self-dealing transaction in which Earthstone's controlling stockholder, private equity firm EnCap Investments L.P. ("EnCap"), merged its cash-starved and struggling portfolio company, Bold Energy III LLC ("Bold"), into Earthstone in a transaction that provided Bold with more than 60% of the combined equity and EnCap with a substantially higher ownership percentage (the "Transaction").

As the Complaint alleges and Earthstone's own documents show, "Bold d[id] not have enough cash and drilling capacity to continue to run the company."[1] Also, EnCap was "looking to sell Bold" because "EnCap ha[d] reached its total capital commitment" and "did not think that the current management of Bold could take the Company public."[2] Having failed to locate a single interested buyer for Bold during a 2015 sale process—and with EnCap realizing that Bold could not be

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[1] A82.

[2] *Id.*

taken public—a merger of Bold and Earthstone had become EnCap's only viable option.

EnCap therefore turned to Earthstone's Chief Executive Officer, Frank Lodzinski ("Lodzinski"), whose previous business ventures were bankrolled by EnCap. Bold and Lodzinski engaged directly for months without telling Earthstone's board of directors (the "Board"). Finally, approximately five months into the Transaction process, Lodzinski informed the Board of his negotiations and that he "intend[ed] to make [an] offer" for Bold,[3] then proceeded to do so by furnishing EnCap with two valuation proposals for Bold contemplating that Bold would own approximately 60% of a combined company, and Earthstone would own approximately 40%.

Despite its awareness that Lodzinski planned to make EnCap an offer for Bold, Earthstone's Board did nothing in response, and waited approximately three more months before finally forming a special committee (the "Special Committee" or "Committee"). By that time, Lodzinski and EnCap had already created a "timeline" and "action plan" in order "to complete the proposed transaction,"[4] and

[3] A73.

[4] A78-79, A85-86.

had discussed the executive management and board composition of the combined entity.[5]

When the Special Committee's financial advisor, Stephens, Inc. ("Stephens"), finally got involved, it advised that its initial contribution analysis did not support the implied valuations that Lodzinski had furnished EnCap months earlier—*i.e.*, a proposed 60/40 split in Bold's favor—because ***Earthstone*** would be contributing 60% of the value to the combined entity and Bold just 40%. Nevertheless, the Committee deferred to Lodzinski's previous engagement with EnCap (before the Special Committee was formed) and directed Stephens to revise its analysis to make it more favorable to Bold and less favorable to Earthstone. The Committee directed Stephens to execute that revision despite Stephens's explicit warning that doing so could compromise the validity of the analysis.

Following two more months of negotiations that the Special Committee allowed Lodzinski to continue to lead, the Committee approved a transaction on terms consistent with Lodzinki's and EnCap's prior dealings, in which existing Earthstone stockholders received slightly below 40% of the combined entity and Bold stockholders received slightly more than 60%.

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[5] A82-83, A85-86.

In an opinion dated July 20, 2018 (the "Opinion" or "Op."), the Court of Chancery dismissed the Action under Court of Chancery Rule 12(b)(6), holding that Defendants "structured the Transaction in the manner prescribed in [*MFW*]," and that the "*MFW* framework was well-executed by all concerned."[6] Specifically, the trial court found that the Transaction satisfied *MFW*'s "*ab initio*" or "outset" requirement because *MFW* protections were proposed in the first ***formal*** offer, which the Special Committee authorized on August 19, 2016 (the "August 19 Letter" or the "Letter"), approximately ***eight months*** into the Transaction process. The trial court also found that the Special Committee satisfied its duty of care and that Earthstone stockholders who voted to approve the Transaction were fully-informed.

[6] Op. at 41.

SUMMARY OF ARGUMENT

1. ***Misapplication of MFW's Ab Initio Requirement and Delaware Pleading Standards***. The trial court erred in concluding that the Transaction satisfied *MFW*'s "*ab initio*" requirement. Although the trial court correctly observed that *ab initio* timing is satisfied only where *MFW* protections are implemented "'before any negotiations [take] place,'"[7] the trial court erroneously held that: (i) "for purposes of the *MFW* analysis," negotiations do not commence until "a proposal is made by one party which, if accepted by the counter party, would constitute an agreement between the parties"; and (ii) the approximately eight months of significant dealings between Lodzinski and EnCap that preceded the August 19 Letter, "while extensive, never rose to the level of bargaining: they were entirely exploratory in nature." Op. at 43, 46.

First, the trial court's holding is at odds with *MFW*, which requires implementation of the dual protections "up-front" and "from the time of the controller's first overture"[8]—not merely the point at which a "definitive proposal" is made. Op. at 46. The trial court's novel *ab initio* formulation renders pre-offer

[7] Op. at 43 (quoting *In re Synutra Int'l, Inc.*, 2018 WL 705702, at *2 (Del. Ch. Feb. 2, 2018)).

[8] *MFW*, 88 A.3d at 638, 644 (quoting *In re MFW S'holders Litig.*, 67 A.3d 496, 528 (Del. Ch. 2013)).

dealings irrelevant to the *MFW* analysis, permitting controllers to negotiate unconstrained before submitting or soliciting a "definitive proposal." Op. at 46. In turn, the trial court's formulation fundamentally undermines the very purpose of *MFW* protections: to "neutralize [a] controller's influence" and ensure that a transaction process "truly mimic[s] arms-length dealing."[9]

Second, by summarily holding that the approximately eight months of substantive dealings between Lodzinski and EnCap "were entirely exploratory in nature" and "never rose to the level of bargaining," the trial court failed to "accept all well-pleaded factual allegations in the Complaint as true" and "draw all reasonable inferences in favor of the plaintiff . . . ." *Cent. Mortg. Co. v. Morgan Stanley Mortg. Capital Hldgs. LLC*, 27 A.3d 531, 536 (Del. 2011) (citation omitted). The well-pled facts alleged in the Complaint establish a clear inference that Lodzinski and EnCap bargained and negotiated before the Special Committee was even formed, including that Lodzinski expressly told the Board he "intend[ed] to make [an] offer" for Bold,[10] and then followed through on that commitment by furnishing two valuation proposals to EnCap.

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[9] Op. at 43 (citing *In re MFW S'holders Litig.*, 67 A.3d at 528).
[10] A73.

Third, the trial court erred by holding that the August 19 Letter was sufficient to satisfy *MFW*. The August 19 Letter was a proposal by the Special Committee (***not the controller, EnCap***), that EnCap did not accept. No fact alleged in the Complaint or otherwise within the motion to dismiss record establishes that EnCap ever ***actually agreed*** to the *MFW* conditions, much less at the outset of the Transaction process.

Fourth, the trial court should not have considered the August 19 Letter at all, because it was not "integral" to the Complaint and was instead selectively proffered by Defendants in connection with their motions to dismiss. The Complaint accurately alleges that neither the Transaction proxy statement (the "Proxy") nor the Company's 220 production (the "220 Production") so much as hint at ***attempted*** (let alone actual) "up-front" *MFW* compliance.

2. ***The Special Committee Failed to Act with Due Care***. The trial court erred in holding that the Special Committee satisfied its duty of care. In reaching this conclusion, the trial court improperly rejected well-pled allegations that the Special Committee: (i) sat idly for months after learning that Lodzinski was engaged in negotiations with EnCap/Bold; (ii) allowed Lodzinski to continue negotiations with EnCap despite his conflict; and (iii) failed to remove Lodzinski from the process.

3. ***The Proxy Was Materially Incomplete***. The trial court further erred in holding that the minority stockholder vote was fully-informed despite the Board's failure to disclose that: (i) Stephens's initial contribution analysis did not support the Transaction, and that the Committee thereafter directed Stephens to change its analysis despite Stephens's express warning that doing so "could provide less meaningful results" (A103, A105-06, A112-13); and (ii) that EnCap's motivation for the Transaction was that Bold faced a liquidity crisis that jeopardized EnCap's investment in the struggling company, and the Transaction with Earthstone was EnCap's only viable solution. *See, e.g.*, *Appel v. Berkman*, 180 A.3d 1055, 1060 (Del. 2018).

STATEMENT OF FACTS

A. Background Of Earthstone, EnCap And Oak Valley

In 2012, EnCap—a private equity and venture capital firm specializing in oil and gas investments—injected $150 million into Oak Valley Resources, LLC ("Oak Valley"), a holding company formed and managed by Lodzinski. A49, A54-55. This gave EnCap control of Oak Valley, as EnCap held a majority of Oak Valley's equity and appointed Lodzinski and three EnCap partners or officers as a majority of the five-member group that managed Oak Valley (the "Board of Managers"). A57.

Armed with EnCap's cash and what Lodzinski himself described as a "long relationship" with EnCap, Lodzinski pursued acquisitions for Oak Valley. A55. Through a December 2014 reverse merger, Oak Valley acquired 84% of the outstanding common stock of Earthstone. A54, A62-65. Through its majority stake in Oak Valley, EnCap became Earthstone's controlling stockholder. A58-59.

From December 2014 through June 20, 2016, EnCap owned more than 50% of Earthstone and otherwise controlled Earthstone's business and affairs, replacing six of Earthstone's seven board members with Oak Valley/EnCap representatives and appointing a new management team headed by Lodzinski. *Id.*

In mid-June 2016, months ***after*** the Transaction process began, Earthstone conducted a stock offering that reduced EnCap's ownership in Earthstone to 41.1%. A60-61. But EnCap, through Oak Valley, retained control of Earthstone as reflected in Earthstone's filings with the U.S. Securities and Exchange Commission (the "SEC"), which warned investors of the potential disadvantages "in owning the stock of ***a company with a controlling stockholder***," and confirmed that Oak Valley "will continue to be able to ***strongly influence all matters requiring stockholder approval, regardless of whether or not other stockholders believe that a potential transaction is in their own best interests***." A61-62 (emphasis added). With the exception of the appointment of Earthstone director Phil D. Kramer, the composition of Earthstone's Board and management remained the ***same*** following the secondary offering up until commencement of the Transaction, and Oak Valley/EnCap loyalists dominated Earthstone's Board and management. *Id.*

B. Bold Faces A Liquidity Crisis

Prior to the Transaction, EnCap-owned approximately 96% of Bold's equity. A41. Bold was an early-stage oil and gas company whose assets consisted mostly of undeveloped acreage, and which was running out of cash to fund its operations. A66-68. In 2015, Bold faced a liquidity crisis that jeopardized EnCap's

investment in the struggling company. *Id.* Without a cash infusion, "Bold did not have enough cash and drilling capacity to continue to run the company . . . ." A68.

EnCap was reaching the end of its capital commitment to Bold, and therefore sought a solution that would not require EnCap to inject more capital. A84. In or around June 2015, Bold hired investment banker Tudor, Pickering and Holt ("TPH") to broadly shop Bold. A68. That effort failed. *Id.* Thus, in November 2015, Lodzinski proposed that EnCap combine Earthstone and Bold. A68-69. The proposed combination was extremely attractive to EnCap, as it would bail Bold out of its liquidity crisis, functionally render Bold a public company without an initial public offering, and relieve EnCap from having to inject additional cash into Bold. *Id.* In addition, EnCap would enjoy substantial tax benefits because the Transaction permitted EnCap to defer tax liability resulting from the Transaction until the newly-issued shares in the combined entity were sold or converted. A85-86.

C. Lodzinski And EnCap Engage For Months Regarding A Bailout Of Bold By Earthstone

In mid-November 2015, Lodzinski and Earthstone management: (i) reviewed a pitch presentation Bold had used during its earlier sale efforts; (ii) held a conference call with EnCap to discuss an Earthstone-Bold merger; and (iii)

entered into a confidentiality agreement. A69-70. EnCap also granted Earthstone access to Bold's data room. A70. In early December 2015, Lodzinski and Earthstone management met with TPH, and on December 8, 2015, Earthstone entered into another confidentiality agreement, this time directly with Bold. A70-71. From mid-December 2015 through mid-January 2016, Lodzinski and his team met not only with EnCap and Bold, but also with three investment banks to pursue an Earthstone-Bold merger. *Id.*

In January 2016, a decline in oil and gas prices forced a temporary cessation of Lodzinski's substantive discussions with EnCap. A71. Critically, to that point in time, Lodzinski had neither sought permission to begin talks with EnCap regarding an Earthstone-Bold merger nor informed the Earthstone Board of his ongoing negotiations with EnCap, and neither he nor anyone else had discussed conditioning any transaction upon special committee or disinterested stockholder approval. A71-72. Indeed, Earthstone conceded in the Proxy that "[t]he Earthstone board was not informed of [Lodzinski's discussions with EnCap and Bold] at the time." A290.

D. Lodzinski Belatedly Informs The Board That He, On Behalf Of Earthstone, "Intend[s] To Make An Offer" For Bold

By April 2016, oil and gas prices were improving, and Lodzinski and EnCap resumed their active pursuit of a deal. ¶79. On April 27, 2016, Lodzinski sent the Board an 8-page status update that informed the Board in a single line item that he intended to make EnCap an offer for Bold. The relevant line item read: "b. Bold – updating analysis and ***intend to make offer***." A73 (emphasis added).

Without waiting to discuss his plan at the upcoming May 3, 2016 Board meeting, Lodzinski and his Earthstone management team continued pursuing a merger with Bold, meeting with EnCap on April 29, 2016. A73-74.

E. The Board Sits Idly By And Permits Lodzinski To Negotiate An Earthstone/Bold Transaction

On May 11, 2016, Lodzinski and his team presented EnCap a proposal that valued Bold at $305 million. A76-77. On May 18, 2016, Lodzinski presented EnCap a second proposal that valued Bold at $335 million. A77. ***Neither proposal was conditioned on approval of a special committee or a majority-of-the-minority stockholder vote***. A76-77.

On June 3, 2016, EnCap Managing Director and Earthstone director Brad Thielemann emailed Lodzinski a "suggested action plan" for the Transaction. A78. On July 6, 2016, Lodzinski and EnCap discussed a proposed "timeline" for

deal completion which included the assignment of "responsibilities to complete the proposed transaction." A79-80.

Throughout all this activity, the Earthstone Board sat idly by and did nothing. A80.

F. The Board Belatedly Forms A Special Committee, Which Allows Lodzinski To Steer Earthstone Into The Transaction Despite Myriad Red Flags

On July 22, 2016, Lodzinski and other members of Earthstone's management team informed the Special Committee that Bold "does not have enough cash and drilling capacity to continue to run the company even with its final capital call to EnCap (which it intends to make in the next week) . . . ." A83-84. Lodzinski also informed the Committee that "EnCap is looking to sell Bold because . . . EnCap has reached its total capital commitment and EnCap does not think that the current management of Bold could take the Company public." A84.

That same day, the Committee "noted that any directors affiliated with EnCap would be kept out of the flow of information and any information regarding prices or valuations should only be communicated to the Special Committee." A84-85. But it was too late: Lodzinski had already communicated to EnCap, on several occasions, Earthstone's proposed valuation for Bold. Indeed, he had even shared Earthstone's valuation model with EnCap. A77-78. At the July 22, 2016

meeting, Lodzinski also presented the results of his extensive negotiations with EnCap to date, which included a merger plan complete with a proposed structure, tax benefits for EnCap, and valuation figures. A85-87.

On July 29, 2016, the Earthstone Board passed a resolution forming the Special Committee.[11] A80, A83. Meanwhile, Earthstone's and Bold's operational teams continued to meet, and Lodzinski met with Bold's Chief Financial Officer to cement the details of sensitive matters such as the management of the post-Transaction entity and the compensation of directors. A82-83.

On August 10, 2016, Lodzinski presented to EnCap and the Earthstone Board his plans to ***announce*** the Transaction in "Q3/Q4" (*i.e.*, ***potentially the following month***). A88.

On August 16, 2016, Stephens presented its initial financial analysis to the Committee, which contradicted the valuations Lodzinski had already presented to EnCap. A88-90. Whereas Lodzinski's proposals had allocated only 40% of the equity in the new company to Earthstone (leaving 60% for Bold), Stephens's analysis revealed the opposite: that Earthstone should receive 62% and Bold should only receive 38%. A89-90. Stephens's analysis also revealed that the

[11] Prior to this time, the Committee had acted on a merely *de facto* basis. *See* A83.

Company's financial projections improperly discounted its stock price by 10%. *Id.* Thus, Stephens advised the Committee that "[Stephens's] analysis does not support the currently proposed split between the Company and Bold." *Id.* Stephens offered that "if the contribution analysis went out to 2019 instead of 2018, it would show a much larger contribution from Bold which would change the results of the analysis." A103. Stephens expressly warned the Committee, however, that including post-2018 data "***could provide less meaningful results***." *Id.* (emphasis added). The Committee nevertheless instructed Stephens to include this data in its analysis, which significantly depressed the value of the Transaction to Earthstone. *Id.*

G. The Special Committee Acquiesces To The Transaction

On August 19, 2016, the Committee authorized Lodzinski to send an offer letter to Bold (previously defined as the "August 19 Letter"). A91-92. Notably, the $325 million valuation of Bold in Lodzinski's offer fell neatly within the $305 million to $335 million range that Lodzinski had already communicated in his two proposals to EnCap in May 2016. *Id.*[12]

[12] Defendants neither included the August 19 Letter in the 220 Production nor disclosed in the Proxy anything other than the financial terms of the August 19 Letter. A92. Further, nothing in the Proxy nor the 220 Production suggests (i) that any party sought or agreed in August 2016 to condition the Transaction upon

Lodzinski then continued his campaign with the Committee and Stephens to allocate more value to Bold. A96-97. Despite its commitment to keep EnCap-affiliated directors "out of the flow" of information (A85), the Committee authorized Lodzinski to "speak directly to the representatives of Stephens regarding the valuation." A96, A115.

At a September 23, 2016 meeting, Lodzinski informed the Committee that "the parties have agreed on a transaction" that resulted in a "61% interest in the surviving company for Bold," and therefore only a 39% interest for Earthstone. A97. Throughout October 2016, Lodzinski turned his focus to negotiating employment agreements for Earthstone's directors and management and securing directorships in the post-Transaction entity for each Earthstone director. A98, A101-02.

Earthstone and Bold agreed on November 7, 2016 that Earthstone stockholders would receive only 39% and Bold stockholders would receive 61% of the combined entity. A45-46, A99. That same day, (i) the Committee

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approval of the Special Committee or a majority-of-the-minority stockholder vote, or (ii) whether or when EnCap and/or Bold proposed or accepted any such conditions. *Id.*

unanimously recommended that the Board approve the Transaction, and (ii) the Board did so. A101-02.

H. The Board Omits Material Information From The Proxy

On April 7, 2017, the Company filed with the SEC a definitive proxy statement (previously defined herein as the "Proxy") recommending that Earthstone's stockholders approve the Transaction. A112. The Proxy was materially misleading with several critical omissions including: (i) that Stephens alerted the Committee that "the contribution analysis does not support the currently proposed [Transaction]," and that thereafter the Committee directed Stephens to change its analysis despite Stephens's express warning that doing so "could provide less meaningful results" (A88-90, A103-06, A112-13); and (ii) EnCap's motivations for the Transaction, specifically, that EnCap was "looking to sell Bold" because Bold faced a liquidity crisis that jeopardized EnCap's investment in the struggling company, and the Transaction with Earthstone was EnCap's only viable solution (A83-84, A116-17).

<u>ARGUMENT</u>

I. THE TRIAL COURT ERRED IN FINDING THAT THE TRANSACTION SATISFIED *MFW*'S *AB INITIO* REQUIREMENT

A. Question Presented

Whether the trial court erred in concluding that the Transaction was conditioned *ab initio* upon the procedural protections required by *MFW*, and thus entitled to business judgment deference, where:

1) *MFW* protections were not even ***proposed*** until the August 19 Letter, or more than ***eight months*** into the Transaction process;

2) The Complaint's well-pled allegations establish a clear inference that Earthstone and its controlling stockholder bargained and negotiated, including with respect to economic matters, before the August 19 Letter and before the Special Committee was even formed;

3) The ***sole*** reference in the record to upfront *MFW* conditions is the August 19 Letter, which: (i) was a proposal by Earthstone, rather than the controller, and nothing in the record indicates that the controller ever ***accepted*** those conditions, let alone at the outset of the Transaction process; and (ii) was withheld from Defendants' 220 Production, and instead first introduced in Defendants' motions to dismiss. This issue was preserved for appeal. A194-99, A918, A171-76, A920, A924-25.

B. Scope of Review

This Court's review of a trial court's grant of a motion to dismiss under Rule 12(b)(6) is *de novo*. *Brinckerhoff v. Enbridge Energy Co.*, 159 A.3d 242, 252, 261 (Del. 2017).

C. Merits of the Argument

1. *MFW* Protections Were Not in Place *Ab Initio*

The trial court held that the Transaction satisfied *MFW*'s *ab initio* requirement because *MFW* protections were proposed in the August 19 Letter, which the trial court found marked the "the start of negotiations. . . ." Op. at 45. According to the trial court, "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." Op. at 43. Regarding the approximately eight months of substantive dealings between EnCap and Lodzinski that preceded the August 19 proposal, the trial court summarily held that they were mere "'discussions' about the possibility of a deal" that "were entirely exploratory in nature" and were therefore of no legal consequence under *MFW*. Op. at 46.

(a) The Trial Court Erred In Holding That The *MFW* Conditions Needed To Be In Place Merely By The Time Of The First Legally Binding Offer

The trial court's holding that "*ab initio*" compliance requires the imposition of *MFW* protections merely by the time a "definitive proposal" is made (Op. at 46) is incorrect as a matter of law. *MFW* protections are intended to "neutralize [a] controller's influence" such that the transaction process "truly mimic[s] arms-length dealing." Op. at 43 (citing *In re MFW S'holders Litig.*, 67 A.3d at 528). Where a controller substantively engages the corporation regarding a potential transaction but does not agree to *MFW* protections until a "definitive proposal" is made (Op. at 46), the controller has not actually "disable[d] itself from using its control to dictate the outcome of the negotiations." *MFW*, 88 A.3d at 646. Rather, the controller's ability to impact the deal is left largely unchecked. Among other things, and as happened in this Action, the controller can: (i) secure the advance support of members of management, who can ultimately influence the special committee and its advisors; and (ii) solicit pricing terms favorable to the controller that, while not legally binding on either party, restrict the special committee in future negotiations.

Accordingly, no Delaware authority other than the Opinion holds that *ab initio* compliance is met so long as the first legally-binding offer proposes *MFW*

conditions. To the contrary, the case law underscores that *ab initio* timing means "up-front," "[f]rom the outset," "from the time of the controller's ***first overture***,"[13] or "***from inception*** to negotiation and approval of the merger" [14]—*i.e.*, from the very beginning to the very end.

The trial court's novel *ab initio* construction appears to have been based on a misreading or unwarranted extension of two Court of Chancery decisions: *In re Synutra International, Inc. Stockholder Litigation*, 2018 WL 705702 (Del. Ch. Feb. 2, 2018) and *In re Books-A-Million Stockholders Litigation*, 2016 WL 5874974 (Del. Ch. Oct. 10, 2016). In those cases, the controller did not engage with the company prior to submission of a formal transaction proposal, and therefore the court determined in each case that a formal proposal marked the beginning of the transaction process. *See, e.g.*, *See*, *e.g.*, *Synutra,* 2018 WL 705702, at *2-3 ("Neither the complaint nor the Proxy suggest any meetings or negotiations took place" before a follow-up offer announcing the conditions); *Books-A-Million,* 2016

[13] *MFW*, 88 A.3d at 638, 644 (quoting *In re MFW*, 67 A.3d at 528); *In re MFW*, 67 A.3d at 502, 514, 527 (emphasis added).

[14] *In re Cox Commc'ns, Inc. S'holder Litig.*, 879 A.2d 604, 643-44 (Del. Ch. 2005) (emphasis added) ("Put simply, if a controller proposed a merger, subject from inception to negotiation and approval of the merger by an independent special committee and a Minority Approval Condition, the business judgment rule should presumptively apply.") (footnote omitted).

WL 5874974, at *8-9 (after special committee rejected controller's offer three years earlier, a 2015 proposal was "a different offer, and it generated a separate process"). Where a formal proposal truly comes before any negotiations with the controller, the *ab initio* requirement is likely satisfied. But in neither of those decisions did the Court of Chancery hold or even suggest, as the trial court does here, that, irrespective of the parties' prior course of dealing, *ab initio* timing is satisfied so long as the first "definitive proposal" contains *MFW* protections. Op. at 46.

The trial court's ruling also creates perverse incentives for controllers that are directly at odds with the incentives that *MFW* intended to create. "'By giving controlling stockholders the opportunity to have a . . . transaction reviewed under the business judgment rule," *MFW* encourages controllers "to give minority stockholders much broader access to the transactional structure that is most likely to effectively protect their interests." 88 A.3d at 643 (quoting *In re MFW*, 67 A.3d at 528 (citation omitted)). The trial court's ruling instead incentivizes controllers to delay agreeing to the *MFW* protections by holding back a formal offer but nevertheless substantively engaging with the company until the controller gains

comfort that a transaction can be obtained on favorable terms.[15] At that point, the controller can submit a "definitive proposal" containing the *MFW* conditions. Op. at 46. This is precisely what the *ab initio* requirement was intended to prevent: a controller using its insider status to orchestrate an unfair transaction, or dangling procedural protections late in the process to secure deal closure or a better deal for itself. *See MFW*, 88 A.3d at 644.

(b) The Trial Court Erred By Failing To Draw Reasonable Inferences That Bargaining Or Negotiations Occurred Before The August 19 Letter

Without the benefit of discovery into the ***months*** of Transaction-related dealings that the trial court itself described as "substantial" and "extensive," the trial court conclusively found that "Lodzinski's discussions with EnCap . . . never rose to the level of bargaining" and were "entirely exploratory in nature." Op. at 45-46. The trial court could not have reached that conclusion had it accepted "all well-pleaded factual allegations in the Complaint as true" and drawn "all

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[15] The Court of Chancery recognized this concern in *Books-A-Million*. 2016 WL 5874974, at *8 ("The Complaint does not allege that the Anderson Family delayed establishing the conditions . . . .").

reasonable inferences in favor of the plaintiff . . . ." *Cent. Mortg. Co.*, 27 A.3d at 536 (citation omitted).[16]

In its recitation of the facts, the trial court acknowledged Lodzinski's long history of Transaction-related dealings with EnCap that the Complaint alleges occurred prior to the August 19 Letter. *See* Op. at 46. But when it summarily held that no bargaining or negotiations occurred prior to August 19, the trial court did not address the specific facts alleged or the reasonable, Plaintiff-friendly inferences arising therefrom.

For example, the Complaint alleges—quoting the 220 Production—that Lodzinski expressly told the Earthstone Board on April 27, 2016 that he "***intend[ed] to make [an] offer***" to acquire Bold. A73 (emphasis added). The Complaint further alleges that shortly thereafter, on May 11 and May 18, 2016, Lodzinski's management team proposed to EnCap two equity valuations for Bold's assets, for $305 million and $335 million, respectively:

- More than two months before the Special Committee was even formed, "[o]n May 11, 2016, without having retained any independent

[16] *See also, e.g.*, *Sandys v. Pincus*, 152 A.3d 124, 128 (Del. 2016) ("'[T]he court is bound to draw all reasonable inferences from . . . particularized facts in favor of the plaintiff, not the defendant, when dismissal of a derivative complaint is sought.'") (quoting *Del. Cty. Emps. Ret. Fund v. Sanchez*, 124 A.3d 1017, 1022 (Del. 2015)).

financial advisor, Earthstone management delivered a presentation to EnCap concerning the proposed combination that indicated an equity valuation for Bold of approximately $305 million in shares of Earthstone stock." A76.

- "A week later, on May 18, 2016, Earthstone management made another pitch to EnCap for Bold, upping its bid to indicate an equity valuation for Bold of approximately $335 million in shares of Earthstone common stock." A77.

In finding that no negotiations or bargaining occurred prior to the August 19 Letter, the trial court ignored numerous reasonable inferences, including that: (i) the May 11, 2016 proposal was the "offer" that Lodzinski told the Board he was going to make; and (ii) bargaining or negotiation occurred after the May 11 proposal, leading Lodzinski and his team to make a second, higher offer on May 18, 2016. Even if these were not the *most* logical inferences to draw from these facts (and Plaintiff submits they are), they are reasonable inferences that the trial court was required—but failed—to draw in Plaintiff's favor. *Cent. Mortg. Co.*, 27 A.3d at 537.

Further, the Complaint alleges detailed facts regarding the substantive dealings that transpired among Lodzinski, EnCap, Bold and TPH in May, June, and July 2016 ***before*** the formation of the Special Committee:

- On May 23, 2016, Earthstone had communications with EnCap and TPH and provided them with access to its data room, including Earthstone's "***corporate model of Earthstone and Bold as well as a***

model of Earthstone's net asset valuation." A77-78 (emphasis added).

- In June 2016, Earthstone met with Bold and TPH to "***discuss[] Bold's assets***" and "***the current asset and divestiture market***," and Earthstone even proposed "'***a suggested action plan to be carried out over the course of the ensuing weeks and months***, relating to a possible transaction . . . . EnCap and Earthstone then held a teleconference on June 7, 2016 concerning the plan of action . . . ." A78 (emphasis added).

- Also in June 2016, Earthstone and Bold management met at Earthstone's offices "concerning the proposed transaction" and then at EnCap's offices with TPH to discuss "***the equity market's likely receptivity to a combination of Earthstone and Bold***." A78-79 (emphasis added).

- On July 6, 2016, Earthstone met with EnCap and its counsel at EnCap's offices to, according to the Proxy, "***develop a preliminary timeline*** to complete a possible transaction, identify the participants and their counsel, and ***assign responsibilities to complete the proposed transaction***." A79-80 (emphasis added).

These facts create a reasonable inference that negotiations or bargaining occurred, including with respect to economic matters. Indeed, the descriptions of these interactions seem to describe "negotiations" or "bargaining" without actually using those words. For instance, it is likely, and certainly reasonably conceivable, that when Earthstone and EnCap "discussed Bold's assets" and "a suggested action plan," negotiations or bargaining occurred regarding the value of Bold's assets. Likewise, when the parties discussed the "equity market's likely receptivity to a

combination of Earthstone and Bold," it is at least reasonably conceivable that part of that conversation involved negotiations or bargaining over the terms of the proposed business combination, and how Earthstone's stockholders would react to those terms.

The trial court even appears to have contradicted its own holding by repeatedly referring to pre-August 19 Letter dealings as "negotiations." For instance, the Opinion refers to the August 19 Letter as "***the first real move in the negotiating bout***," implying that a "negotiating bout" was already underway. Op. at 46 (emphasis added). Elsewhere the trial court characterized Lodzinski's interactions with EnCap and Bold prior to the August 19 Letter as "negotiations." Op. at 21-22 ("During a meeting of the Special Committee on July 22, 2016, Lodzinski and Anderson . . . updated the Special Committee ***on the status of negotiations that had occurred thus far***.") (emphasis added); *id.* at 29 ("Lodzinski ***continued to serve*** as Earthstone's lead ***negotiator*** following delivery of the [August 29] Offer Letter") (emphasis added).

2. The August 19 Letter Does Not Satisfy *MFW*

(a) The Letter Does Not Reflect An Agreement By EnCap To The *MFW* Protections

The trial court held that the August 19 Letter satisfied the *ab initio* requirement because the Letter purportedly "made clear to Bold and EnCap that

the 'procession of the transaction' would be subject to *MFW* protections." Op. at 45 (citation omitted). But *MFW* requires more than a clear statement of a ***board's*** aspirations; it requires ***the controller*** to actually "disable[] ***itself*** from using its control to dictate the outcome of the negotiations and the shareholder vote . . . ." *MFW*, 88 A.3d at 644. That is, a board can propose whatever protections it likes, but if ***the controller*** "***does not agree*** to both protections up front, then the most that the controller can achieve is a shift in the burden of proof." *In re Ezcorp Inc. Consulting Agreement Deriv. Litig.*, 2016 WL 301245, at *11 (Del. Ch. Jan. 25, 2016) (emphasis added); *see also MFW*, 88 A.3d at 645 ("[I]n controller buyouts, the business judgment standard of review will be applied *if and only if*: (i) ***the controller*** conditions the procession of the transaction on the approval" conditions) (first emphasis in original).

Here, the August 19 Letter does not reflect an agreement by the controller, let alone an upfront one. The Letter is a proposal by the Committee—not EnCap—that EnCap ***rejected*** twelve days later by submitting a written counteroffer. A295; *see also* Comment a, Restatement (Second) of Contracts § 39 (1981) ("[A] counter-offer is a rejection, and it does have the same effect in terminating the offeree's power of acceptance."). EnCap's counteroffer is not before this Court

because the Company withheld it from its 220 Production and Defendants omitted it from their selective *MFW* proffer. *See infra* at § I(C)(2)(b).

The reasonably conceivable inference that EnCap never agreed to the *MFW* protections—much less on or around August 19—is further supported by the critical fact, ignored by the trial court in its Opinion, that the Proxy neither states nor suggests that EnCap proposed that the "procession of the transaction"[17] would be subject to *MFW* protections. Indeed, despite mentioning the August 19 Letter, the Proxy does not even hint that it referred to either special committee or unaffiliated stockholder approval. A295.

This is more than sufficient under the low reasonable conceivability standard[18] to "call into question the existence of" an upfront agreement by EnCap. *Books-A-Million*, 2016 WL 5874974, at *8 (quoting *Swomley v. Schlecht*, 2014 WL 4470947, at *20 (Del. Ch. Aug. 27, 2014), *aff'd*, 128 A.3d 992 (Del. 2015)). Indeed, the Proxy's complete silence as to *MFW* compliance should be dispositive at the pleading stage. Experienced counsel drafted the Proxy fully aware that "[i]f the defendants have described their adherence to the elements identified in [*MFW*] 'in a public way suitable for judicial notice, such as board resolutions and a proxy

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[17] *MFW*, 88 A.3d at 645.

[18] *See Cent. Mortg.*, 27 A.3d at 536.

statement,' then the court will apply the business judgment rule at the motion to dismiss stage . . . ." *Books-A-Million*, 2016 WL 5874974, at *8 (citation omitted).

Thus, the reasonable inference is that if the Transaction in fact satisfied *MFW*, the Proxy would have said so. On the other hand, if the Transaction did not comply with *MFW*—as is the case here—the Board would not have disclosed the August 19 Letter's ***proposal*** of *MFW* protections (as is also the case here), lest the Proxy "disclos[e] only part of the story, and leav[e] the reader with a distorted impression" that the Transaction satisfied *MFW*. *Appel*, 180 A.3d at 1064.

(b) The Trial Court Erred By Considering The August 19 Letter On The Motions to Dismiss

Finally, the trial court erred by even considering the August 19 Letter, which the trial court labeled "integral" to the Complaint. Op. at 44 n.200. The Letter was not "integral" to the Complaint, and the trial court's finding that Plaintiff "expressly relie[d] upon the Offer Letter (albeit selectively)" is misplaced. *Id.*

While there is no "bright-line rule," generally a "document is integral to the claim if it is ***the source . . . for the facts as pled in the complaint***." *In re Gardner Denver, Inc. S'holders Litig.*, 2014 WL 715705, at *3 (Del. Ch. Feb. 21, 2014) (emphasis added) (internal citations and quotation marks omitted). "Integral" documents are those that are extensively cited or quoted in a complaint, or which

are the foundational documents from which a plaintiff's claims arise. *See, e.g.*, *Allen v. Encore Energy P'rs, L.P.*, 72 A.3d 93, 96 n.2 (Del. 2013) (finding a proxy statement integral "because [plaintiff] quote[d] from and cite[d] the Proxy Statement almost exclusively in making his allegations regarding the Merger negotiation process and Vanguard's motivations for the transaction"); *Gerber v. EPE Hldgs., LLC*, 2013 WL 209658, at *1 n.12 (Del. Ch. Jan. 18, 2013) (finding a partnership agreement integral because it was "given a defined term and [was] referred to explicitly and implicitly throughout the Complaint"); *e4e, Inc. v. Sircar*, 2003 WL 22455847, at *3 (Del. Ch. Oct. 9, 2003) (finding a letter integral because "[it] was referred to extensively and was given the status of a defined term by the drafters of the Complaint" and because "much of the wrongful conduct alleged to have been engaged in . . . was taken directly from [it]").

Here, the August 19 Letter is neither the source for any fact pled in the Complaint nor a basis for Plaintiff's claims. Plaintiff filed the Complaint based on publicly-available information and the documents produced in response to Plaintiff's 220 demand. The August 19 Letter was not publicly available, and the Company did not include the Letter in its 220 Production. The Complaint alleges (in a mere two paragraphs) only what the Proxy states about the Letter, namely that it was authorized by the Special Committee, was sent on August 19, 2016,

proposed financial terms, and contained no other material terms. *Compare* A91-92 *with* A295.

Nor does Defendants' strategic attachment of the August 19 Letter to their motions to dismiss render it "integral." "The plaintiff is the master of the complaint"—not the defendant. *NACCO Indus., Inc. v. Applica Inc.*, 997 A.2d 1, 23 (Del. Ch. 2009) (citation and internal quotations omitted). This is especially true where, as here, Plaintiff followed this Court's oft-repeated advice and made a 220 demand (which the Company initially rejected). Defendants had an opportunity to seek "to exculpate themselves" through their document production (*In re Tyson Foods, Inc. Consol. S'holder Litig.*, 919 A.2d 563, 578 (Del. Ch. 2007)), but elected not to do so. Defendants should not have been—and should not be—permitted to curate a self-serving record.

II. THE TRIAL COURT ERRED IN FINDING THAT THE SPECIAL COMMITTEE ACTED WITH DUE CARE

A. Question Presented

Whether Plaintiff's allegations concerning Lodzinski's negotiations with EnCap and the Special Committee's failure to remove Lodzinski from the process create a reasonably conceivable inference that the Special Committee breached its duty of care.[19]

B. Scope of Review

This Court's review of a trial court's grant of a motion to dismiss under Rule 12(b)(6) is *de novo*. *See Brinckerhoff*, 159 A.3d at 252, 261.

C. Merits of Argument

This Court recognizes that "'[w]hen a committee is structurally independent, has a sufficient mandate and ***cannot be bypassed*** and fulfills its duty of care, it should be given standard-shifting effect.'" *Empls. Ret. Sys. of St. Louis v. TC Pipelines GP, Inc.*, 152 A.3d 1248 n.9 (Del. 2016) (TABLE) (quoting *In re MFW*, 67 A.3d at 518) (emphasis added). But if a "special committee lack[s] ***one*** of these essential attributes, [] the committee [will not be] given weight." *In re MFW*, 67 A.3d at 518 (emphasis added). Further, "'[t]o obtain the benefit of burden shifting,

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[19] This issue was preserved for appeal. *See* A200, A203-09.

the controlling stockholder must do more than establish a perfunctory special committee of outside directors.' Rather, the special committee must '***function in a manner*** which indicates that the controlling stockholder did not dictate the terms of the transaction . . . .'" *MFW*, 88 A.3d at 646 (quoting *Kahn v. Tremont Corp.*, 694 A.2d 422, 429 (Del. 1997) (emphasis added) (footnote omitted).

Here, Plaintiff's well-pled factual allegations establish, at a minimum, a reasonably conceivable pleading-stage inference that the Special Committee was unable to "function in a manner" that limited EnCap's ability to "dictate the terms of the transaction" in satisfaction of its duty of care. The Special Committee was not formally established until July 29, 2016, more than ***eight*** months after Lodzinski initiated the Transaction process. A83. By this time, Lodzinski had already, among other things: (i) engaged in substantive negotiations with EnCap for several months (A68-72; A290-91); (ii) informed the Board that he "intend[ed] to make an offer" for Bold on Earthstone's behalf (A73); (iii) bracketed Bold's value in negotiations by proposing to EnCap a range of valuations of Bold (A76-77); (iv) executed NDAs and exchanged confidential information with EnCap (A70, A77-80); (v) created a "timeline" and "action plan" with EnCap "to complete the proposed transaction" (A78-80, A85-87); and (vi) discussed various Transaction structures and side deals with EnCap including proposed management

and board composition (A82-83, A85-86). Plaintiff's allegations further demonstrate a reasonable inference that even after the Committee's belated formation, it acted with gross negligence by immediately permitting Lodzinski to—as the trial court acknowledged—"spearhead negotiations of the merger on behalf of the Special Committee" (Op. at 57; A87-88, A91-96) and "speak directly to the representatives of Stephens regarding the valuation" (A96).

Lodzinski's self-proclaimed "long-relationship" and on-going business dealings with EnCap represented a clear conflict that rendered him unable to disinterestedly represent Earthstone and the minority stockholders and therefore disqualified him from negotiating against EnCap on behalf of the Special Committee. A50, A54-57, A122-24. Moreover, as a member of the Board of Managers of Oak Valley—a controlled subsidiary of EnCap which held EnCap's bloc of Earthstone shares (A55-57, A59-62, A122-23)—Lodzinski harbored divided loyalties giving rise to the conflicting pull of competing fiduciary roles. *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) ("There is no 'safe harbor' for such divided loyalties in Delaware.").

Despite this conflict, the Special Committee (i) authorized Lodzinski's continued negotiations directly with EnCap (A92-96), and (ii) allowed Lodzinski to "speak directly to the representatives of Stephens regarding the [Transaction]

valuation" (A96). Indeed, by allowing Lodzinski to "spearhead" these negotiations (Op. at 57), the Special Committee violated its own decree that "***any directors affiliated with EnCap would be kept out of the flow of information*** . . ." (A85 (emphasis added)).

Instead of drawing the reasonable Plaintiff-friendly inference that the Committee might have breached its duty of care and failed to exercise "real bargaining power 'at an arms-length'" (*MFW*, 88 A.3d at 646 (quoting *Tremont*, 694 A.2d at 429)), the trial court improperly drew defense-friendly inferences to conclude the opposite. In addressing Lodzinski's lead role in the negotiations, the trial court erroneously disregarded Lodzinski's significant ties to EnCap and concluded that "it can hardly be viewed as remarkable that a chairman and CEO [would] spearhead negotiations . . . ." Op. at 57. By disregarding Lodzinski's prior negotiations and ignoring Lodzinski's ongoing conflict with EnCap, the trial court ignored years of well-established Delaware precedent holding that directors who delegate the task of negotiating a deal to conflicted management do not receive business judgment rule protection. *See Tremont*, 694 A.2d at 429-30 ("[The Directors] abdicated their responsibility as committee members by permitting Stein, the member whose independence was most suspect, to perform the Special Committee's essential functions."); *McPadden v. Sidhu*, 964 A.2d

1262, 1270-71 (Del. Ch. 2008) (holding that "tasking [a conflicted manager] with the sale process" constituted a breach of the duty of care); *Crescent/Mach I P'rs, L.P. v. Turner*, 846 A.2d 963, 982 (Del. Ch. 2000) (finding that independent directors breached their duty of loyalty "by acquiescing in [the CEO's] self-interested negotiations and by approving the merger at an unfair price").

Applying this principle in *In re Jefferies Group, Inc. Shareholders Litigation*, the Court of Chancery concluded that similarly alleged facts constituted a "well-pled allegation [of] a duty of care breach." C.A. No. 8059-CS, 6:13-14 (Del. Ch. Nov. 4, 2013) (TRANSCRIPT). In *Jefferies*, four conflicted directors initiated deal negotiations "without full board authorization, including sharing confidential nonpublic information with Leucadia [a counter party]." *Id.* at 6:4-5. A committee of directors was established after the conflicted directors "had already been discussing the deal [with Leucadia] for ***five months,***" but even "[w]hen the committee was finally formed, ***it reverted immediately to allowing the same conflicted directors to do the price negotiations***." *Id.* at 66:19-22, 67:4-12 (emphasis added). In concluding that these facts raised a reasonable pleading stage inference of a breach of the duty of care, the Court of Chancery determined that "this newly formed transaction committee hardly responded in a way that creates

an ***indisputable pleading-stage inference of the satisfaction of the due care***." *Id.* at 66:15-18; 67:4-12 (emphasis added).

Here, like in *Jefferies*, Lodzinski pursued an extensive period of unchaperoned negotiations with EnCap (five months of which occurred absent Board knowledge or authorization), during which he, *inter alia*, entered into NDAs, exchanged confidential information, performed substantive two-way due diligence, exchanged valuations of Bold and Earthstone, and created a Transaction "timeline" and "action plan." Upon its belated formation, the Special Committee could have exercised due care and removed Lodzinski from the process, but instead immediately reverted to allowing Lodzinski to represent Earthstone in negotiations despite his clear conflict. The trial court erred in failing to extend to Plaintiff the same pleading-stage inference of a duty of care violation that the Court of Chancery applied in *Jefferies*.

III. THE TRIAL COURT ERRED IN FINDING THAT THE STOCKHOLDER VOTE WAS FULLY INFORMED

A. Question Presented

Whether Plaintiff has alleged facts giving rise to a reasonably conceivable inference that Defendants failed to meet their burden to show the vote on the Transaction was fully informed despite the Board's failure to disclose: (i) that Stephens's initial contribution analysis did not support the Transaction, and that the Special Committee then directed Stephens to revise its initial analysis ***despite*** the Committee's knowledge that the revision would "provide less meaningful results" (A103, A105-06, A112-13); and (ii) EnCap's unique motivations for orchestrating the Transaction.[20]

B. Scope of Review

This Court's review of a trial court's grant of a motion to dismiss under Rule 12(b)(6) is *de novo*. *Brinckerhoff*, 159 A.3d at 252, 261.

C. Merits of Argument

1. Applicable Materiality Standard

"[D]irectors of a Delaware corporation have a fiduciary duty to disclose fully and fairly all material information within the board's control[.]" *Appel*, 180

[20] These issues were preserved for appeal. *See* A209-14, A908-13, A930-33.

A.3d at 1060 (quotations omitted). Omitted facts are material if there is "a substantial likelihood that a reasonable stockholder would consider them important in deciding how to vote." *RBC Capital Mkts., LLC v. Jervis*, 129 A.3d 816, 859 (Del. 2015) (citation and internal quotations omitted). "Materiality 'does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote,' only that such reasonably available information would have impacted upon a stockholder's voting decision." *Id.* (quoting *Rosenblatt v. Getty Oil Co*., 493 A.2d 929, 944 (Del. 1985)).

Materiality allegations "need not be pleaded with particularity," as a plaintiff need only provide "some factual basis . . . from which the Court can infer materiality of an identified omitted fact." *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 146 (Del. 1997). Given the fact-intensive nature of the inquiry, disclosure claims turning on materiality typically raise issues not suitable for disposition at the pleadings stage. *See, e.g.*, *Branson v. Exide Elecs. Corp*., 645 A.2d 568, at *3 (Del. 1994) (TABLE) ("Whether or not a statement or omission . . . was material is a question of fact that generally cannot be resolved on a motion to dismiss, but rather it must be determined after the development of an evidentiary record.").

Finally, "[t]he burden rests on the party claiming ratification to establish that the stockholder approval resulted from a fully informed electorate." *Yiannatsis v. Stephanis ex rel. Sterianou*, 653 A.2d 275, 280 (Del. 1995) (emphasis removed) (internal citation and quotations omitted). *See also, e.g.*, *Corwin v. KKR Fin. Hldgs. LLC*, 124 A.3d 304, 312, n.27 (Del. 2015) ("The burden to prove that the vote was fair, uncoerced, and fully informed falls squarely on the board.") (citation and internal quotations omitted).

2. The Trial Court Erroneously Failed To Find Material That Stephens's Analysis Did Not Support The Transaction, So The Committee Directed Stephens To Revise The Analysis Despite Knowing That The Revision Would Compromise The Results

As set forth *supra* in the Statement of Facts, Sections F and H, Plaintiff alleges that after Stephens's initial contribution analysis revealed that a 60/40 ownership split favoring Bold was unfair to Earthstone, the Special Committee (i) directed Stephens to change its analysis to support the Transaction, and (ii) did so despite Stephens's express warning that revising the analysis in that manner would "provide less meaningful results[.]" A88-89, A103, A105-06, A112-13. The Board omitted these material facts from the Proxy.

Delaware law is clear that financial analyses bearing on the fairness of a proposed transaction—and changes to such analyses directed by a special

committee—are material. *See, e.g.*, *In re Rural Metro Corp. S'holders Litig.*, 88 A.3d 54, 104 (Del. Ch. 2014) ("The financial advisor's opinion of financial fairness for a proposed transaction is one of the most important process-based underpinnings of a board's recommendation of a transaction to its stockholders and, in turn, for the stockholders' decisions on the appropriateness of the transaction.") (citation and internal quotations omitted); *In re Orchard Enters., Inc. S'holder Litig.*, 88 A.3d 1, 21 (Del. Ch. 2014) (finding that a determination of a proxy's accuracy as to a financial analysis could not be made at the summary judgment phase given allegations that the financial advisor "changed its valuation method because the Special Committee said so").

Having learned that Stephens's analysis "d[id] not support the currently proposed ownership split" between Earthstone and Bold (A112-13), like in *Orchard*, the Committee directed Stephens to "change[] its valuation method"[21] in order to support the proposed transaction despite knowing that doing so would "provide less meaningful results" (A103, A105-06, A112-13). The Board failed to disclose these highly material facts, which bear directly on the legitimacy and reliability of the "[t]he financial advisor's opinion of financial fairness" as to the

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[21] 88 A.3d at 21.

Transaction. *Rural Metro*, 88 A.3d at 104 (citation and internal quotations omitted).

The trial court deemed these omissions immaterial as a matter of law on the basis that the inclusion of the 2019 projections and the impact of those projections on the analysis "can be clearly discerned from Stephens's final analysis as disclosed in the Proxy Statement." Op. at 62; *see also id.* at 62-63 ("stockholders could see for themselves how the contribution analysis changes"); (*id.* at 63-64) ("stockholders were given all that was needed to follow Stephens's analyses and ultimate opinions"). However, the mere disclosure of the revised analysis itself, including the 2019 projections and their impact, is no substitute for disclosure of the material facts that: (i) Stephens's initial analysis suggested the Transaction was unfair; (ii) the analysis was revised ***because*** it suggested the Transaction was unfair; and (iii) the Committee directed Stephens to change its analysis despite knowing that the revision would "provide less meaningful results." A103, 105-06, A112-13. Indeed, disclosing the revised analysis and 2019 projections without also disclosing those omitted facts constitutes a quintessentially improper partial disclosure under Delaware law. *See, e.g.*, *Zirn v. VLI Corp.*, 681 A.2d 1050, 1056 (Del. 1996) ("[E]ven a non-material fact can, in some instances, trigger an

obligation to disclose additional, otherwise non-material facts in order to prevent the initial disclosure from materially misleading the stockholders.”).

Finally, the Board’s assertion that Bold’s early developmental stage relative to Earthstone “diminished the relevance of the contribution analysis as an indicator of value” (Op. at 63) cannot excuse the omission of the true reason for including the 2019 projections, or the detrimental impact of that inclusion on the validity of the analysis.[22] Indeed, several facts create a strong inference that the analysis was highly relevant to assessing the Transaction, including: (i) that Stephens chose to run the contribution analysis in initially assessing the Transaction; (ii) that the results of the analysis were sufficiently worrisome that the Committee directed its revision despite knowing that doing so would compromise analytical integrity; and (iii) the difference between Earthstone’s and Bold’s developmental stages (and liquidity positions) was a highly relevant consideration for stockholders, not a reason to disregard an analysis highlighting that divergence. At a minimum, this issue raises a question of fact not suitable for resolution at the pleadings stage. *See, e.g.*, *Branson*, 645 A.2d 568, at *3.

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[22] It is telling that Defendants elected to self-servingly contextualize the contribution analysis within the Proxy, yet omitted the highly material contextual facts of why they revised the analysis and the known consequence of doing so.

3. The Trial Court Erroneously Failed To Find Material EnCap's Motivation For Orchestrating The Transaction

Earthstone Board members were undisputedly aware as of July 22, 2016, that: (i) "Bold d[id] not have enough cash and drilling capacity to continue to run the company even with its final capital call to EnCap" (A84), and (ii) "EnCap ha[d] reached its total capital commitment" in Bold and was "***looking to sell Bold***" (*id.*). Thus, Board members knew that with Bold in dire need of cash and EnCap on the hook for further capital infusions, EnCap's explicit desire to exit its Bold investment gave EnCap strong motivations to engage in a transaction, and in turn gave Earthstone significant leverage to negotiate a favorable deal. Those material facts were omitted from the Proxy.

Particularly given its position as Earthstone's controlling stockholder,[23] EnCap's motivations for engineering a bailout of cash-strapped and struggling Bold constitute material information critical to stockholders' ability to assess the Transaction's fairness. *See, e.g.*, *Sherwood v. Ngon*, 2011 WL 6355209, at *7 (Del. Ch. Dec. 20, 2011) (stating that when a transaction is driven by fiduciaries'

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[23] Even if EnCap had not been Earthstone's controlling stockholder, EnCap's unique motivations for effecting the Transaction would still be relevant given, *inter alia*, EnCap's (i) strong ties with Earthstone's management and Board, which Defendants concede gave it "influence" (A860); and (ii) position as Earthstone's counterparty in the Transaction.

personal interests, the proxy must disclose "'motivations candidly'") (quoting *ODS Techs. L.P. v. Marshall*, 832 A.2d 1254, 1261 (Del. Ch. 2003)); *Eisenberg v. Chi. Milwaukee Corp.*, 537 A.2d 1051, 1059 (Del. Ch. 1987) (noting that stockholders are "entitled to an accurate, candid presentation of why the self-[interested] tender offer is being made"). Indeed, this Court recently reaffirmed that a fiduciary's motivations for pursuing a potential transaction constitute material information requiring disclosure. *See Morrison v. Berry*, 2018 WL 3339992, at *12-13 (Del. July 9, 2018) (requiring full disclosure of stockholder activism that motivated the sale of the company), *revised* July 27, 2018. The omission of EnCap's motivations for the Transaction is particularly noteworthy given that the relevant facts were concisely memorialized within the Special Committee minutes, yet "[s]omehow these words did not find themselves in the [Proxy] submitted to stockholders." *Appel*, 180 A.3d at 1063. *See also id.* ("That a disclosure . . . could have been made succinctly is demonstrated by the minutes . . . which used terse words to convey the important information.").

In finding these omitted facts immaterial as a matter of law, the trial court improperly focused on the naked fact of Bold's "cash position," rather than the independently material fact that Bold's cash position ***motivated*** EnCap to engage in the Transaction, and thus provided Earthstone with significant leverage to

negotiate a favorable deal. *Compare, e.g.*, (A210) ("**The Proxy Omits Material Information Regarding EnCap's Motivation for Orchestrating the Transaction**") (emphasis in original) *with* Op. at 67 ("[T]he Board was not obliged ***to characterize Bold's cash position*** . . . .") (emphasis added).

First, the trial court cited a suggestion from a conflicted member of Earthstone's management[24] that despite reaching the end of its capital commitment to Bold and Bold's severe liquidity issues, EnCap would "'continue funding Bold.'" Op. at 66. But ***whether*** EnCap ultimately would have continued funding Bold (rather than allowing its investment to fail) is not the issue. Rather, the material omitted information revealed that EnCap ***did not want*** to continue funding Bold and was desperate for a transaction to avoid doing so. As the Committee was explicitly informed, Bold's liquidity situation and the lifecycle of EnCap's investment in Bold meant that "EnCap [wa]s looking to sell Bold" and was uniquely motivated to work out a deal for Bold. A84. Indeed, EnCap's recognition that it would need to "continue funding Bold" (Op. at 66) (citing A743) ***amplified*** its motivation to jettison Bold through the Transaction.

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[24] The purveyor of this suggestion, Robert Anderson, served on Oak Valley's board of managers and assisted Lodzinski in pre-baking the Transaction. A59-60, A78-79, A85-86.

Second, the trial court cited financial disclosures that it deemed sufficient to allow stockholders to "assess for themselves Bold's liquidity." Op. at 66. But again, disclosure of raw numbers relating to Bold's cash position are no substitute for disclosure of the independently material fact that EnCap was "looking to sell Bold" and thus uniquely incentivized to orchestrate the Transaction. A84 (quoting A743). Stockholders were not aware of this substantial source of leverage for Earthstone when they voted to approve the Transaction.

CONCLUSION

The trial court's Order granting motions to dismiss, dated July 20, 2018, should be REVERSED.

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Dated: September 13, 2018

Public Unredacted Version
Filed September 28, 2018

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