Delaware Court of Chancery Declines to Apply Business Judgment Deference Due to Deficiencies in MFW Protections

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On August 31, 2021, Vice Chancellor Sam Glasscock of the Delaware Court of Chancery declined to dismiss breach of fiduciary duty claims brought by a former minority stockholder of Isramco, Inc. (the "Company"), which challenged the Company's take-private acquisition by Naphtha Israel Petroleum Corp. (Naphtha). *Joseph Lawrence Ligos v. Isramco, Inc. et al.*, C.A. No. 2020-0435-SG (Del. Ch. August 31, 2021). The motion to dismiss was filed by Haim Tsuff, an indirect controller of the Company. The Court explained that because the Company was controlled by Tsuff and Tsuff also indirectly controlled Naphtha and its affiliates, the Court was required to employ the strict "entire fairness" standard of review in analyzing the plaintiff's claims. Defendant Tsuff argued that the transaction complied with the procedural protections allowing for deferential review under the business judgment standard as articulated in the Delaware Supreme Court's decision in *Kahn v. M & F Worldwide Corp*., 88 A.3d 635 (Del. 2014) (*MFW*). The Court, however, disagreed based on its determination that the stockholder vote to approve the transaction was not fully informed. Therefore, the Court applied the entire fairness standard and declined to dismiss the complaint under Rule 12(b)(6).

In order for a conflicted transaction to be entitled to business judgment deference under *MFW*, the company and its controller must demonstrate compliance with two conditions. First, the deal must be subject ab initio to negotiation by a committee of independent and disinterested directors fully empowered and in compliance with the duties of loyalty and care. Second, the transaction must also be so subject to a "majority of the minority" stockholder vote in favor by a fully informed and uncoerced electorate. As the *Isramco* court explained, "Compliance with the *MFW* rubric allows conflicted transactions to receive business judgment review, but given the agency risk, compliance with the rubric is strictly construed."

In *Isramco*, the Court determined that a material omission from the Company's proxy (the "Proxy") precluded business judgment review under *MFW*. The complaint alleged that a material factor in arriving at a fair value of Isramco was the value of certain overriding royalties in an offshore Israeli oil field, the Tamar Field, in which another entity, Isramco Negev 2 Limited Partnership (Negev 2), owned a working interest. The value of the royalties in turn was dependent on when the right to receive royalties ripened, a matter on which Isramco and Negev 2 disagreed. The royalty issue, at the time of the merger, was in arbitration. Negev 2 was yet another entity controlled by Tsuff. The value of the royalties and the value of the arbitration were material to the deal price.

According to the Proxy, some facts about the arbitration, and the value of the arbitration assigned by the financial advisor to the special committee formed by the Company's board of directors (the "Board") to consider the transaction, were disclosed to the minority stockholders. Stockholders were told that Naphtha, the merger counterparty, held a controlling interest in Negev 2, which was involved in the arbitration. What they were not told was that at about the time Tsuff formed a desire for Naphtha to acquire Isramco, he approached the Board for permission to allow Tsuff himself to participate in the arbitration, and the Board agreed. Under the plaintiff-friendly motion to dismiss standard, the Court assumed that having received permission of the Board to participate, Tsuff did so, and he pursued his own, conflicted self-interest in that arbitration.

The plaintiff alleged that Tsuff's self-interest included prolonging the arbitration throughout the merger negotiations to keep Isramco's value artificially reduced. Though the Court was unprepared to confirm that conclusion, it determined that the Board's agreement to allow Tsuff to participate, and the participation itself, would have been material to a stockholder attempting to evaluate the proposed merger. Accordingly, the Court ruled that business judgment review under *MFW* was unavailable to the defendants, and thus the motions to dismiss were denied. This opinion is a good reminder for directors on corporate boards to err on the side of disclosure of facts that may be considered material in the context of an interested transaction—no matter how beneficial it may be—in order to take advantage of the deferential business judgment standard of review. In this case, had the Company disclosed that Tsuff had approached the Board for permission to allow Tsuff himself to participate in the arbitration and that the Board had agreed, the defendants may have successfully demonstrated compliance with the *MFW* rubric. Where a transaction concerns a direct or an indirect controlling stockholder, directors should take care to remember that all facts weighing on the controller's interests are likely to be considered material.