



IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

NICHOLAS OLENIK, Individually and
on Behalf of All Others Similarly Situated
and Derivatively on Behalf of Nominal
Defendant EARTHSTONE ENERGY,

C.A. No.: 2017-0414-VCS

Plaintiff,

v.

PUBLIC VERSION
FILED JUNE 7, 2017

FRANK A. LODZINSKI, RAY
SINGLETON, DOUGLAS E.
SWANSON, BRAD THIELEMANN,
ROBERT L. ZORICH, JAY F. JOLIAT,
ZACHARY G. URBAN, PHILLIP D.
KRAMER, ENCAP INVESTMENTS
L.P., BOLD ENERGY III LLC, BOLD
ENERGY HOLDINGS LLC and OAK
VALLEY RESOURCES, LLC,

Defendants,

and

EARTHSTONE ENERGY, INC, a
Delaware corporation,

Nominal Defendant.

**VERIFIED STOCKHOLDER CLASS ACTION AND
DERIVATIVE COMPLAINT**

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I. NATURE OF THE ACTION

Plaintiff Nicholas Olenik (“Plaintiff”), on behalf of himself and all other similarly situated stockholders of Earthstone Energy, Inc. (“Earthstone” or the “Company”), and for the benefit of nominal defendant Earthstone, brings the following Verified Stockholder Class Action and Derivative Complaint (the “Complaint”) against (a) Frank A. Lodzinski (“Lodzinski”), Ray Singleton (“Singleton”), Douglas E. Swanson (“Swanson”), Brad Thielemann (“Thielemann”), Robert L. Zorich (“Zorich”), Jay F. Joliat (“Joliat”), Zachary G. Urban (“Urban”), Phillip D. Kramer (“Kramer”) (collectively the “Board” or “Director Defendants”) for breaching their fiduciary duties as directors of Earthstone; (b) EnCap Investments L.P. (“EnCap”) and Oak Valley Resources, LLC (“Oak Valley,” and together with EnCap, the “Control Group Defendants”) for breaching their fiduciary duties as the Company’s controlling stockholders; (c) Lodzinski for breaching his fiduciary duties as an officer of the Company, and (d) Bold Energy III LLC (“Bold”), Bold Energy Holdings LLC (“Bold Holdings,” and together with Bold, the “Bold Defendants”) for aiding and abetting the aforementioned breaches of fiduciary duties. The allegations of the Complaint are based on the knowledge of Plaintiff as to himself, and on information and belief, including the investigation of counsel, the review of publicly-available information, and the review of certain books and records produced by the

Company in response to Plaintiff's demand made under 8 *Del. C.* § 220 (the "Section 220 Demand" or "220 Demand"), as to all other matters.

II. INTRODUCTION

1. This action arises from a conflicted transaction in which the EnCap-controlled Earthstone Board agreed to merge the Company with Bold, a nascent EnCap portfolio company that was rapidly running out of money (the "Transaction"). As detailed below, the Transaction was orchestrated and negotiated by conflicted parties that favored their own interests and the interests of EnCap over the interests of Earthstone and its public stockholders. The Transaction bestows on EnCap at least two significant benefits not shared with the Company or its non-EnCap affiliated stockholders: (i) a bailout for EnCap's investment in struggling, cash-strapped Bold and (ii) significant tax savings. In sharp contrast, Earthstone and its public stockholders are being deprived of their fair share of the combined company.

2. Private equity firm EnCap controlled Earthstone, an oil and gas development company. Before the Transaction and at all relevant times, EnCap and its affiliated investment funds owned and controlled 41.1% of Earthstone and exercised control over Earthstone, Oak Valley and the Bold Defendants. As confirmed by the documents produced in response to Plaintiff's Section 220 Demand and the Company's own public filings, Earthstone is a mature oil and gas

company with strong cash flows that enabled the Company to weather the 2015-2016 storm of record-low oil prices.

3. In addition to its control over Earthstone, EnCap also controlled Bold, a private, early-stage oil and gas exploration and production company whose assets consisted principally of undeveloped acreage. Specifically, EnCap owned approximately 96% of Bold's outstanding equity.

4. Severely depressed oil prices in 2015-2016 put significant stress on Bold's cash flows, causing Bold to burn through millions of dollars in cash in developing its assets. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

5. In light of Bold's incipient and struggling status, EnCap's motive for the Transaction was simple. EnCap either needed to sell Bold or find a partner willing to provide the capital Bold badly needed to continue operations. In the summer of 2015, EnCap shopped Bold to potential buyers in an attempt to obtain a capital infusion, but was unsuccessful. Recognizing that there was little interest

for Bold's undeveloped assets (at least at the inflated price that EnCap was demanding), EnCap resorted to "Plan B"—a merger of Bold with EnCap-controlled Earthstone, which would eliminate the need for EnCap to provide Bold with a capital infusion.

6. To this end, EnCap and Lodzinski – Earthstone's Chairman, President, and chief executive officer ("CEO"), and the founder, former President and CEO of Oak Valley, which was financially backed by EnCap – spent months secretly orchestrating a potential merger of Earthstone and Bold without informing the Earthstone Board. Lodzinski went so far as to, among other things, provide Bold with confidential, internal Earthstone information and present Bold with his views on Bold's value, which effectively locked Earthstone into overpaying to merge with Bold.

7. In April 2016, Lodzinski finally informed the Earthstone Board regarding the advanced deal discussions with Bold. Over the next several months, while the Board held its own Board meetings at EnCap's Houston office, the Board inexplicably allowed Lodzinski and senior Earthstone management to establish a data room and exchange confidential internal Earthstone information with Bold/EnCap, devise an "action plan to be carried out during the ensuing weeks and months," and conduct an on-site tour of Bold's field facilities.

8. By the time the Board officially formed a special committee (the

“Special Committee”) near the end of July 2016, the Transaction was a *fait accompli*. As detailed herein, the Special Committee was neither “independent” nor well-functioning. Once formed, the Special Committee retained Stephens, Inc. (“Stephens”) as its financial advisor but struggled to secure from Stephens an opinion that the range of consideration that Lodzinski had negotiated was fair.

9. The Special Committee was not well-functioning in several ways.

Among other things, the Special Committee:

- a. allowed senior management with ties to EnCap to participate in and guide the process while simultaneously negotiating their continued employment;
- b. failed to secure a majority-of-the-minority stockholder approval condition from the outset of the sales process;
- c. violated its own mandate by granting Lodzinski express permission to negotiate the final Transaction consideration with Stephens;
- d. ignored red flags identified by Stephens’ financial analysis, which highlighted the unfairness of the Transaction consideration; and
- e. failed to secure a collar, walk-away right or other mechanism to protect the Company from overpaying despite management informing the Special Committee that it believed that “its stock price will increase based on the proposed transaction.”

10. On November 7, 2016, Earthstone and Earthstone Energy Holdings, LLC (“EEH”), a newly-formed, wholly-owned subsidiary of Earthstone, entered

into a Contribution Agreement (the “Contribution Agreement”)¹ with Lynden USA Operating LLC, Lynden USA, Inc., Bold Holdings and Bold. Under the Contribution Agreement, Earthstone agreed to acquire all of the outstanding membership interests and assets of Bold through a complex “Up-C” Transaction in exchange for contributing all of its assets to the newly-formed holding company. The Transaction resulted in Earthstone stockholders owning just 39% of the combined company’s outstanding equity.

11. The Transaction is unfair to Earthstone and its public stockholders for a multitude of reasons.

12. *First*, Earthstone is contributing the bulk of the assets and revenues to the combined company in exchange for a minority, 39% equity interest. Indeed, the Transaction terms were so one-sided that Stephens needed to significantly alter its contribution analysis mid-process just to be able to opine that the Transaction consideration was fair to Earthstone. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

¹ The Contribution Agreement was subsequently amended on March 21, 2017 to extend the termination date of the Contribution Agreement from March 31, 2017 to June 30, 2017.

[REDACTED]

[REDACTED]

[REDACTED] the Special Committee, with the assistance of Stephens and Company management, added 2019 EBITDA to the final contribution analysis – which suddenly made the Transaction look fair to Earthstone and its disinterested stockholders.

13. *Second*, the consideration paid to Earthstone does not account for the significant degree of risk thrust upon the Company as a result of its merger with cash-strapped Bold, a company in the early stages of development and whose assets consist principally of undeveloped acreage. Bold, meanwhile, will receive the capital it needs to fund ongoing operations and use Earthstone's established cash flows to grow its undeveloped assets, all without EnCap having to invest additional funds of its own.

14. *Third*, the Transaction does not compensate Earthstone and its public stockholders for the extremely valuable tax benefits bestowed on Bold (*i.e.*, EnCap) through the Transaction, nor the cost savings associated with avoiding an initial public offering ("IPO"). The "Up-C" structure of the Transaction uniquely benefitted EnCap by conferring tax savings [REDACTED]

[REDACTED]

[REDACTED] Prior to the Transaction, Bold was a privately-held

limited liability company, and therefore not an ideal entity to take public through an IPO. By utilizing the Up-C structure, EnCap transformed Bold from (a) a privately-held company into (b) a privately-held company that owned and controlled assets of a publicly-traded company through its 61% ownership of Earthstone. As a result, EnCap was essentially able to take Bold public even though there was likely no market for it.

15. The Transaction is subject to the entire fairness standard. EnCap controlled Earthstone, stood on both sides of the Transaction, uniquely benefitted from the Transaction, and caused harm to both Earthstone and its stockholders.

16. Plaintiff brings this Action to hold (a) EnCap and Oak Valley (previously defined herein as the “Control Group Defendants”) liable for their breaches of fiduciary duty in their capacity as Earthstone’s controlling stockholders, (b) the Director Defendants liable for their breaches of fiduciary duty, (c) Lodzinski liable for breaching his fiduciary duties as an Earthstone officer, and (d) the Bold Defendants liable for aiding and abetting the foregoing breaches of fiduciary duty.

III. THE PARTIES

17. Plaintiff is and has been, at all relevant times, a record owner of shares of Earthstone common stock.

18. Nominal defendant Earthstone (formerly known as “Basic Earth

Science Systems, Inc.”) is an oil and natural gas company founded in 1969. Earthstone is incorporated in the State of Delaware and has its corporate headquarters at 1400 Woodloch Forest Drive, Suite 300, The Woodlands, Texas 77380. Prior to the closing of the Transaction, Earthstone’s stock traded on the New York Stock Exchange MKT (“NYSE MKT”) under the ticker symbol “ESTE”. Following the closing of the Transaction, Earthstone’s stock has been uplisted to the New York Stock Exchange.

19. Defendant EnCap is a private equity and venture capital firm that is structured as a Delaware limited partnership and bills itself as “the leading provider of venture capital to the independent sector of the U.S. oil and gas industry.” EnCap and its affiliated investment funds, as described *infra*, exercised control over Earthstone, Oak Valley and the Bold Defendants at all times relevant to Plaintiff’s allegations. As of the November 8, 2016 public announcement of the Transaction, EnCap owned 41.1% of Earthstone’s outstanding common stock through Oak Valley.

20. Defendant Bold was an early-stage oil and gas company structured as a Texas limited liability company and focused on the acquisition, development and production of unconventional, oil-weighted reserves in the Midland Basin of West Texas.

21. Defendant Bold Holdings was a Texas limited liability company

established on November 4, 2016 as a vehicle to facilitate the combination of Earthstone and Bold.

22. Defendant Oak Valley is a Delaware limited liability company controlled by EnCap, and through which EnCap controlled Earthstone prior to the consummation of the Transaction.

23. Defendant Lodzinski has served as Earthstone's Chairman, President, and CEO since December 2014. Previously, he founded and served as President and CEO of Oak Valley from its formation in December 2012 until its combination with Earthstone in December 2014. Lodzinski has a longstanding relationship with EnCap.² EnCap is Oak Valley's largest investor and financial backer. As detailed herein, over the years, EnCap has provided Lodzinski and Oak Valley the capital needed to pursue investments in multiple companies in the upstream oil and gas space.

24. Defendant Singleton has been a director of Earthstone since July 1989 and was its President and CEO from March 1993 until the Company's December 2014 combination with Oak Valley, at which time Singleton became Executive Vice President of Earthstone's Northern Region.

25. Defendant Swanson has been a director of Earthstone since December 2014. He also serves as a Managing Partner of EnCap, which he joined in 1999,

² See *infra* sections IV(A)(2) - (3) and IV(B).

and as a manager of Oak Valley.

26. Defendant Thielemann has been a director of Earthstone since December 2014. He also serves as a Managing Director of EnCap, which he joined in 2006.

27. Defendant Zorich has been a director of Earthstone since December 2014. He also serves as a Managing Partner of EnCap, which he co-founded in 1988, and as a manager of Oak Valley.

28. Defendant Joliat has been a director of Earthstone since December 2014. He owns a membership interest in Oak Valley. He was a member of the Special Committee formed in connection with the Transaction.

29. Defendant Urban has been a director of Earthstone since December 2014. He owns a membership interest in Oak Valley. Mr. Urban currently serves as CEO at Vlastic Group, which is a private investment company with holdings in a wide variety of asset classes and has a history of making investments in companies led by Lodzinski. He was also a member of the Special Committee.

30. Defendant Kramer has been a director of Earthstone since October 2016.

31. Defendants identified in Paragraphs 23 through 30, *supra*, are referred to collectively as the “Director Defendants” or the “Board”.

IV. SUBSTANTIVE ALLEGATIONS

A. Background of Earthstone And Its Relationship With Oak Valley And EnCap

1. Earthstone's Reverse Merger With Oak Valley

32. Earthstone is an upstream³ oil and natural gas company focused on the acquisition and development of onshore crude oil and natural gas reserves. The Company's primary assets are located in the Midland Basin of West Texas, the Eagle Ford Shale of South Texas, and the Williston Basin of North Dakota. Earthstone represents that, as part of its business model, it is "active in corporate mergers and the acquisition of oil and natural gas properties that have production and future development opportunities."

33. EnCap took control of Earthstone in December 2014 as a result of a transaction in which Earthstone issued a controlling share of its stock to Oak Valley, which is controlled by EnCap (the "Reverse Merger").

³ The oil and gas industry generally divides into "upstream," "downstream," and "midstream" operations. Upstream operations are those concerned with the identification of oil and gas deposits, well drilling, and the recovery of raw materials from underground. Downstream operations are those concerned with turning raw materials into usable products such as gasoline and marketing those products. Midstream operations are those concerned with linking upstream and downstream operations through resource transportation and storage, including the operation of pipelines and gathering systems. See Investopedia, "What Is The Difference Between Upstream and Downstream Oil and Gas Properties?," <http://www.investopedia.com/ask/answers/060215/what-difference-between-upstream-and-downstream-oil-and-gas-operations.asp> (last accessed May 18, 2017).

34. The Reverse Merger was effected pursuant to an exchange agreement between Oak Valley and Earthstone (the “Exchange Agreement”), dated May 15, 2014 (and as amended September 26, 2014). Under the terms of the Exchange Agreement, Oak Valley contributed its membership interests in three subsidiaries (including productive assets, undeveloped acreage and an estimated \$138 million in cash) to Earthstone in exchange for approximately 9.1 million shares of Earthstone common stock. After the Reverse Merger closed in December 2014, Earthstone’s pre-Reverse Merger stockholders owned approximately 16% of the Company’s outstanding common stock while Oak Valley owned and controlled 84% of the Company’s outstanding common stock.

2. Background Of Oak Valley And Its Relationship With EnCap

35. Because EnCap controls Oak Valley, the Reverse Merger caused EnCap to control Earthstone.

36. Lodzinski founded Oak Valley on December 14, 2012, and served as its President and CEO prior to the Reverse Merger. Oak Valley operates as a holding company for purposes of pursuing investment opportunities in upstream oil and gas companies. Oak Valley’s investment strategy includes acquiring companies with upstream assets and then installing its own management team to run the newly-acquired company.

37. EnCap is Oak Valley’s largest investor. EnCap provided Lodzinski

and Oak Valley with the capital to pursue investments in the upstream space. On December 21, 2012, one week after Lodzinski founded Oak Valley, affiliates of EnCap bet on Lodzinski by capitalizing his fledgling company with a portfolio of valuable assets. In return, Lodzinski granted EnCap membership interests in Oak Valley. According to a presentation given by Lodzinski at the January 21, 2014 IPAA⁴ Private Capital Conference, EnCap's asset contribution "[p]rovided immediate cash flow and upside potential" for Oak Valley.⁵ In the same presentation, Lodzinski confirmed that EnCap has a "[l]ong relationship with [Oak Valley] Management."⁶ The same day that Lodzinski gave his presentation, EnCap affiliates [and others] infused Oak Valley with \$150 million in cash.

38. As a result of its investments, EnCap owns a majority of Oak Valley's equity and controls the Oak Valley board of managers. EnCap has been the largest investor in Oak Valley at all times since it made its initial investment with Lodzinski the week after he founded the venture. EnCap has also served as Lodzinski's financial backer for many of Oak Valley's, and now Earthstone's, significant investments. Earthstone's most recent Annual Report on Form 10-K, filed with the SEC on March 15, 2017 (the "2016 10-K"), confirms that affiliates

⁴ The acronym "IPAA" refers to the Independent Petroleum Association of America.

⁵ Frank A. Lodzinski, IPAA Private Capital Conference, "Scorecard for Success," Jan. 21, 2014, http://www.ipaa.org/meetings/ppt/2014PCC/OakValley_Lodzinski_Frank.pdf (last accessed Apr. 6, 2017).

⁶ *Id.*

of EnCap “own a majority of the membership interests of OVR [*i.e.*, Oak Valley].”

The Company’s proxy statement issued in connection with the Transaction discloses that “EnCap and its affiliates own approximately 57.3% of the membership interests of Oak Valley”⁷

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

40. The Company’s 2016 10-K also confirms that Oak Valley is run by a “board of managers” (the “Board of Managers”) and that affiliates of EnCap “have the contractual right to nominate a majority of the members of the board of managers.” Oak Valley’s Board of Managers is comprised of the following five members, three of which are also current partners and/or officers of EnCap:

⁷ Earthstone Energy, Inc. Def. Proxy Statement (DEFM14A) (Apr. 7, 2017) (hereinafter the “Proxy”) at 69.

Board of Managers of Oak Valley Resources, LLC

<u>Name</u>	<u>Position</u>	<u>Present Principal Occupation</u>
Frank A. Lodzinski	Manager	President and Chief Executive Officer of Earthstone Energy, Inc.
Robert J. Anderson	Manager	Executive Vice President, Corporate Development and Engineering of Earthstone Energy, Inc.
Bryan T. Stahl	Manager	Vice President at EnCap Investments L.P.
Douglas E. Swanson, Jr.	Manager	Partner at EnCap Investments L.P.
Robert L. Zorich	Manager	Managing Partner at EnCap Investments L.P.

The business address of each member of the Board of Managers of Oak Valley is 1400 Woodloch Forest Drive, Suite 300, The Woodlands, Texas.

41. In addition to serving on Oak Valley's Board of Managers, each member of the Board of Managers owns a non-controlling membership interest in Oak Valley. Notably, Lodzinski owns an approximate 28.4% interest in an entity that owns a 2.6% membership interest in Oak Valley.

3. EnCap Controls Earthstone Through Oak Valley

42. After effecting the Reverse Merger in December 2014, Lodzinski and Oak Valley installed six new members on Earthstone's then-seven member Board, each of whom remain on the Board today and has close ties to EnCap and/or Oak Valley: (1) Lodzinski; (2) Swanson, an EnCap partner and an Oak Valley manager; (3) Thielemann, an EnCap managing director; (4) Zorich, an EnCap founder and partner and an Oak Valley manager; (5) Urban, who owns membership interests in Oak Valley; and (6) Joliat, who owns membership interests in Oak Valley.

43. Lodzinski and Oak Valley also installed a new management team, with Lodzinski becoming the Company's President and CEO, as well as Chairman

of its Board. Singleton stepped down from his role as CEO to a new role as director and Executive Vice President of Earthstone's Northern Region. Additionally, Earthstone now employs several people from Oak Valley Management, LLC ("OVM"), an affiliate and non-controlling member of Oak Valley. According to Earthstone's public filings:

The Company employs members of OVM. For the years ended December 31, 2015, 2014, and 2013, the Company made payments totaling \$3.8 million, \$3.9 million and \$2.2 million, respectively, to these members as compensation for services and reimbursement of expenses.

44. Earthstone's public filings confirm that EnCap has been Earthstone's controlling stockholder since December 2014. From December 2014 through mid-June 2016, EnCap controlled greater than 50% of the equity and voting power in Earthstone through its membership interests in Oak Valley:

- [Oak Valley Resources] OVR *holds a substantial majority of our common stock.*

OVR holds the majority of the outstanding shares of our common stock. OVR is entitled to act separately in its own interest with respect to its shares of our common stock, and it has the voting power to elect all of the members of our board of directors and thereby control our management and affairs.

* * * *

As a result of the share issuance to Flatonia, OVR's ownership in us decreased from 84% to 66%.

[Source: Annual Report Form 10-K at 21, 31, filed March 27, 2015](emphasis added).]

- *We are a “controlled company”* within the meaning of the NYSE MKT rules and, as a result, qualify for, and rely on, exemptions from certain corporate governance requirements. As a result, our stockholders do not have the same protections afforded to stockholders of companies that are subject to such requirements.

[Source: Annual 10-K at 31, filed March 11, 2016) (emphasis added).]

- As discussed above, Oak Valley, which *controls 66.0% of the total voting power* of Earthstone’s outstanding shares of common stock

[Source: Definitive Proxy Statement at 119, filed April 1, 2016) (emphasis added).]

- Our management team has been in place since December, 2014 when we completed a business combination with Oak Valley Resources, LLC, *which currently owns approximately 52% of our outstanding common stock.*

[Source: Prospectus Form 424B5 at S-4, filed June 15, 2016) (emphasis added).]

- “Oak Valley Resources *owns 52% of Earthstone.*”

[Source: Form 8-K at Slide 37, attaching Investor Presentation, filed June 24, 2016) (emphasis added).]

45. Furthermore, there can be no question that EnCap exercised control over Oak Valley’s stake in Earthstone. Earthstone has conceded that because EnCap has *both* board control and share ownership control of Oak Valley, Lodzinski, Anderson, as well as the other members of Oak Valley’s Board of

Managers, “*do not have the sole or shared power to vote or dispose of the shares of common stock of the Company held by Oak Valley.*”⁸ The Company’s public filings and the Proxy further confirm this point:

EnCap Partners and certain of its affiliates through their direct and indirect ownership may be deemed to share the right to direct the disposition of the Common Stock held by Oak Valley *through the EnCap Oak Valley Funds’ interest in Oak Valley* and EnCap Fund IX’s ownership of Bold.⁹

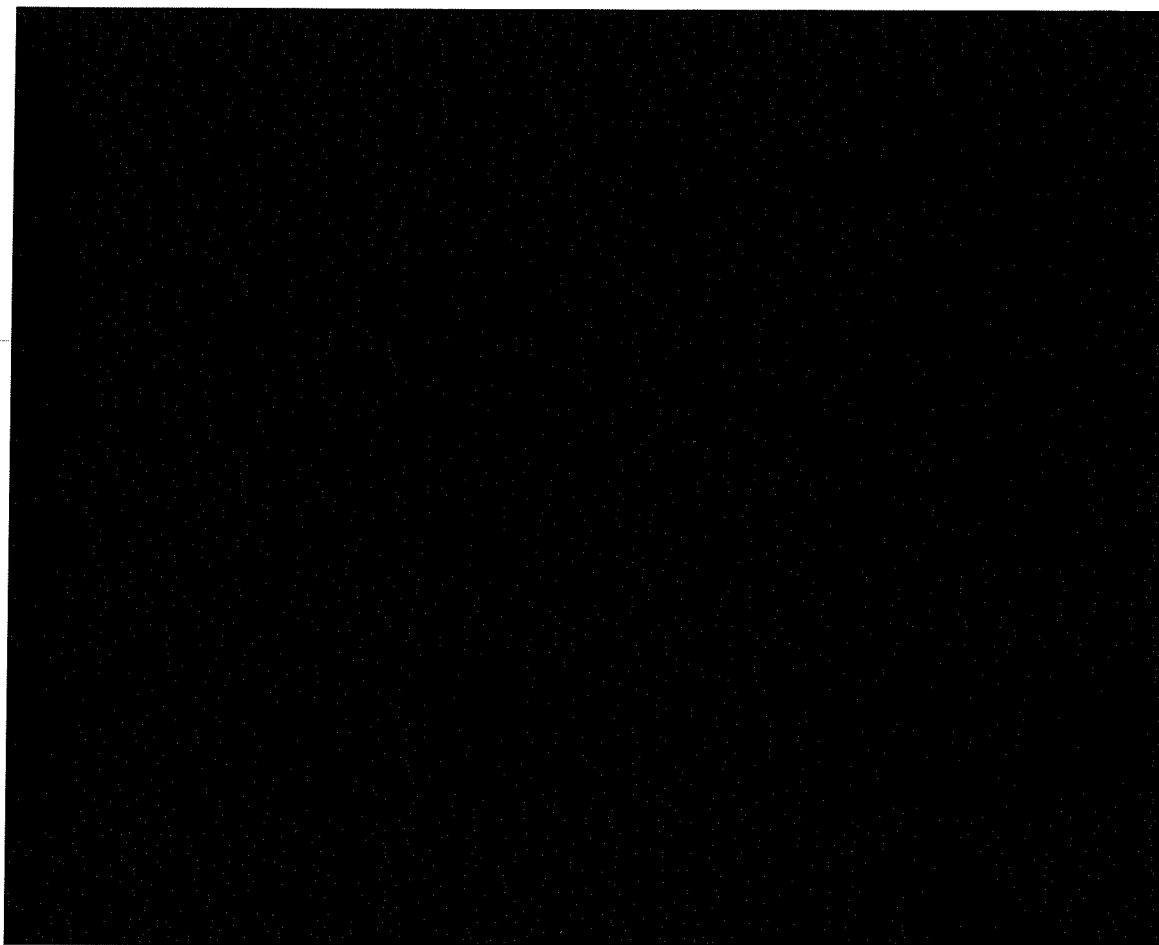
46. In mid-June 2016, *after* negotiations culminating in the Transaction with Bold were well underway, Earthstone conducted a stock offering which brought EnCap’s beneficial ownership interest in Earthstone to approximately 41.1%. [REDACTED]

[REDACTED]

[REDACTED]

⁸ Proxy at 117 (emphasis added); *see also*, Annual 10-K at 71, filed Mar. 15, 2017; Definitive Proxy Statement at 11, filed Oct. 4, 2016; Annual 10-K at 16, filed April 1, 2016; Definitive Proxy Statement at 20, filed Sept. 21, 2015.

⁹ Proxy at 10, 30, 69, 106 (emphasis added); *see also* Preliminary Proxy Statement at 10, 30, 68, 105 filed Dec. 21, 2016; Preliminary Proxy Statement at 10, 30, 69, 106 filed Mar. 24, 2017.



47. After the June 2016 offering, however, EnCap continued to control Earthstone. Directors associated with Oak Valley and EnCap continued to dominate the Board and Earthstone acknowledged the potency of EnCap's 41.1% ownership stake, recognizing that such a stake rendered it a *de facto* "controlling stockholder":

So long as OVR [Oak Valley] continues to control a significant amount of our common stock, OVR 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. In any of these matters, the

interests of OVR may differ or conflict with the interests of our other stockholders. Moreover, this concentration of stock ownership may also adversely affect the trading price of our common stock to the extent investors perceive a disadvantage *in owning stock of a company with a controlling stockholder*. As of March 1, 2017, OVR controls 9,162,452 shares of our common stock, or 41.1% of the outstanding shares.

(Annual 10-K at 27-28, filed March 15, 2017) (emphasis added).

48. Further, Earthstone’s public filings post-dating the June 2016 offering continued to refer to the Company as an “affiliate” of EnCap:

- “Earthstone, Bold and Bold Sub are each affiliates of funds controlled by EnCap Investments LP.”

[Source: Form 8-K filed Nov. 8, 2016.]

- “Earthstone, Bold and Bold Sub are each affiliates of funds controlled by EnCap Partners.”

[Source: Schedule 13-D/A filed by Frank A. Lodzinski, filed on Nov. 16, 2016.]

B. Earthstone Is A Mature, Cash-Generating Enterprise With A Strong Balance Sheet

49. EnCap’s substantial investment in Earthstone provided the Company the capital needed to effectively execute its business strategy of “pursuing value-accretive corporate merger and acquisition opportunities.” Thus, following the Reverse Merger, Lodzinski and Earthstone pursued a year-long acquisition spree that created significant value for the Company and poised it for future success.

50. In December 2014, immediately after the Reverse Merger, Earthstone

acquired a 20% undivided ownership interest in certain crude oil and natural gas properties located in Fayette and Gonzales Counties, Texas in exchange for the issuance of approximately 2.957 million shares of common stock to Flatonia Energy, LLC (“Flatonia”), a portfolio company of Parallel Resource Partners LLC, a private equity firm focused on upstream oil and gas investments.

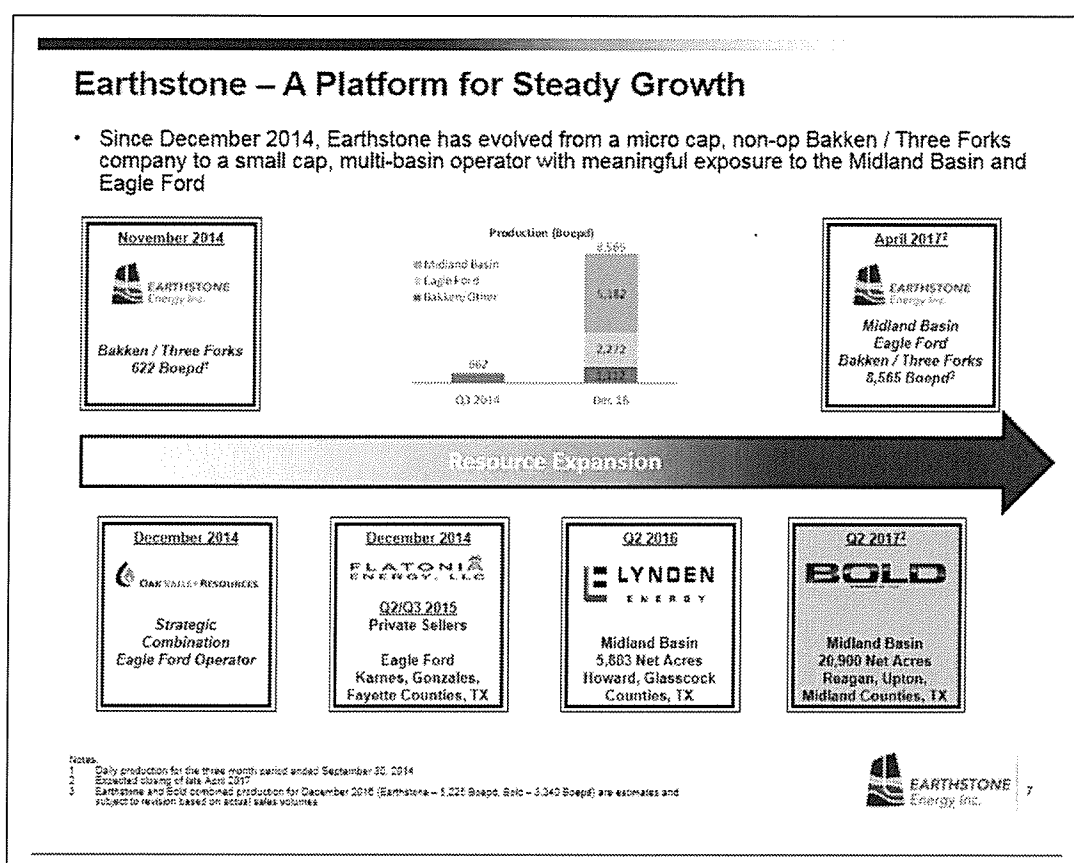
51. Six months later, in June 2015, the Company made several more acquisitions, including: (i) the acquisition of a 50% operated interest in approximately 970 gross acres and two gross Austin Chalk wells in Gonzales County, Texas; (ii) the acquisition of 400 gross acres in northern Karnes County, Texas; and (iii) the acquisition of additional acreage and working interest in certain wells located in the Banks Field of McKenzie County, North Dakota.

52. Two months later, in August 2015, Earthstone acquired a 33% working interest in approximately 1,650 gross acres in southern Gonzales County, Texas.

53. Just three months after the Gonzales County acquisition, Earthstone entered into an Arrangement Agreement with Lynden Energy Corporation (“Lynden”) in an all-stock acquisition valued at about \$67.2 million. Under the terms of the Arrangement Agreement, Earthstone issued approximately 3.7 million shares to Lynden in exchange for Lynden’s assets. Lynden’s primary assets included 14,765 acres in Glasscock, Midland, Martin and Howard counties, Texas.

The Lynden acquisition closed in May 2016. Shortly thereafter, Lodzinski installed Oak Valley's management team to manage and run the newly-acquired assets.

54. Lodzinski and his team, with EnCap's backing, grew Earthstone from a micro-cap company to a small-cap company, as touted in the Company's investor presentation below:¹⁰:



55. Like most upstream companies, Earthstone hit a bump in the road during 2015 and 2016 due to record-low commodity prices. In spite of those conditions, however, Earthstone's own financial statements indicate that the

¹⁰ Earthstone Energy, Inc., Current Report (Form 8-K), (Mar. 17, 2017).

Company's consistent revenues, low debt and access to cash left it better positioned than most other companies in the upstream sector:

(In thousands, except per share and production amounts)		Years ended December 31,									
Summary of Operating Data		2016		2015		2014		2013		2012	
Production											
Oil (MBbl)		878		904		403		163		90	
Natural gas (MMcf)		2,171		2,143		2,132		2,635		2,298	
Natural gas liquids (MBbl)		225		176		124		134		76	
Barrel of oil equivalent (MBOE)*		1,465		1,437		882		737		549	
Average realized prices:											
Oil (per Bbl)	\$	39.13	\$	44.09	\$	86.29	\$	98.32	\$	96.00	
Natural gas (per Mcf)	\$	2.32	\$	2.55	\$	4.39	\$	3.69	\$	2.64	
Natural gas liquids (per Bbl)	\$	12.74	\$	12.29	\$	28.29	\$	28.88	\$	31.00	
Summary of Operations:											
Total revenues	\$	42,269	\$	47,464	\$	47,611	\$	29,634	\$	17,091	
Lease operating, re-engineering and workover expenses	\$	15,067	\$	15,422	\$	10,130	\$	8,122	\$	6,183	
Severance taxes	\$	2,198	\$	2,582	\$	2,002	\$	1,225	\$	608	
Impairment expense	\$	24,283	\$	138,086	\$	19,359	\$	12,298	\$	52,475	
Depreciation, depletion and amortization	\$	25,937	\$	31,228	\$	18,414	\$	17,111	\$	12,191	
Pretax loss	\$	(54,013)	\$	(143,097)	\$	(6,729)	\$	(19,875)	\$	(53,321)	
Income tax expense (benefit)	\$	528	\$	(26,442)	\$	22,105	\$	—	\$	—	
Net loss	\$	(54,541)	\$	(116,655)	\$	(28,834)	\$	(19,875)	\$	(53,321)	
Net loss per share:**											
Basic	\$	(2.92)	\$	(8.43)	\$	(3.11)	\$	(2.18)	\$	(5.84)	
Diluted	\$	(2.92)	\$	(8.43)	\$	(3.11)	\$	(2.18)	\$	(5.84)	
Summary Balance Sheet Data at Year End:											
Net oil and natural gas properties	\$	269,402	\$	198,333	\$	295,877	\$	147,297	\$	63,462	
Total assets	\$	316,512	\$	264,944	\$	451,388	\$	189,858	\$	87,542	
Long-term debt	\$	12,693	\$	11,191	\$	11,191	\$	10,825	\$	10,825	
Total equity	\$	241,457	\$	199,873	\$	316,528	\$	148,922	\$	61,267	

56. Despite record-low oil prices, analysts remained bullish about Earthstone's prospects. For example, one analyst report published in March 2016 recognized that the Company was well-positioned to weather the storm because the Company's "balance sheet remains strong with a nice cash balance, minimum debt, and low expected cash burn rate."¹¹

57. More recently, the Company released a presentation that further illustrates Earthstone's strong cash and mature liquidity position:

¹¹ Jason A. Wangler, *Staying Focused On Controlling Costs Internally and M&A Externally*, Wunderlich Securities, Mar. 15, 2016.

Combined Liquidity

As of February 28, 2017

(\$mm)	Earthstone	Bold	Combined
Cash and Equivalents	9.5	1.9	11.4
Revolver Borrowings	10.0	38.9	48.9
Other Debt	4.2	0.0	4.2
Total Debt	14.2	38.9	53.1
Revolver Borrowing Base ¹	80.0	62.5	142.5
Less: Revolver Borrowings	10.0	38.9	48.9
Plus: Cash and Equivalents	9.5	1.9	11.4
Liquidity	79.5	25.5	105.0

Note:

1 Combined borrowing base subject to redetermination



25

C. Without Informing The Earthstone Board, Lodzinski Initiates Discussions With EnCap To Acquire The Cash-Strapped Bold

58. Prior to the closing of the Transaction, Bold was a privately-owned, early-stage oil and gas company focused on the acquisition, exploration and development of oil and gas properties in the Greater Permian Basin of West Texas and Southeastern New Mexico. Bold, which was formed in March 2013, was a portfolio company of EnCap, which owned and controlled approximately 95.9% of Bold's membership units. EnCap's investment in Bold was made from EnCap Energy Capital Fund IX ("Fund 9"), which was capitalized through a \$5 billion

capital raise completed in January 2013. In 2015, EnCap raised money for a new fund, EnCap Energy Capital Fund X LP (“Fund 10”), which was capitalized through a \$6.5 billion capital raise completed in April 2015.

59. By the summer of 2015, EnCap was reaching the end of its capital commitments to entities sponsored through Fund 9. As a result, EnCap was looking to take Bold public without having to invest additional capital of its own.

60. Oil and gas exploration companies like Bold require large amounts of cash to fund drilling operations.¹² Given this frequent need for capital, oil and gas exploration companies are constantly looking for ways to raise capital to meet their heightened cash needs.¹³

61. The drastic collapse of oil prices in 2015 and 2016 further heightened the need for capital for oil and gas companies. Lower oil prices caused exponentially more stress on smaller companies like Bold.¹⁴ [REDACTED]

[REDACTED]

[REDACTED]

In

¹² Rob Purdy, Shane Randolph and Matt Smith, *E&P Hedging During The Price Downturn*, Oil & Gas Financial Journal (Mar. 16, 2016), <http://www.ogfj.com/articles/print/volume-13/issue-3/features/energy-banking/e-p-hedging-during-the-price-downturn.html>.

¹³ *Id.*

¹⁴ The Guardian, *Oil Price Falls to 11-year Low With Global Glut Expected To Deepen in 2016*, (Dec. 21, 2015), <https://www.theguardian.com/business/2015/dec/21/brent-crude-oil-price-11-year-low>.

light of the downturn in oil prices, Bold struggled financially and was unable to continue operations. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

62. In light of Bold's dire need for cash, Bold retained Tudor, Pickering, Holt & Co. ("TPH") in or around June 2015 to "determine whether there was a market for Bold's assets." After an extensive and unsuccessful three-month market check, no buyer emerged for Bold. In light of falling oil prices and EnCap reaching the end of its Fund 9 capital commitments, Bold was desperate for a capital infusion.

63. At the same time, Lodzinski remained focused on pursuing further acquisitions to bring additional assets under his management at Earthstone. After learning that Bold was unable to find a buyer, Lodzinski, without informing the members of the Board, initiated discussions with EnCap regarding a potential transaction with Bold in November 2015. In the course of those discussions, Lodzinski proposed a combination of Earthstone and Bold.

64. Lodzinski's overture presented an attractive opportunity for EnCap. A combination of Earthstone and Bold would provide the cash Bold desperately needed, while allowing EnCap to take Bold public without an IPO. Lodzinski, for

his part, stood to significantly increase the assets under his management while currying additional favor from his financial backer and largest Oak Valley investor, EnCap. As a result, Lodzinski and EnCap worked toward making the proposed combination a reality.

65. On November 12, 2015, EnCap provided Lodzinski and his Earthstone management team with a presentation that TPH had used during the prior summer to market Bold to potential buyers. Five days later, on November 17, 2015, Lodzinski and other members of Earthstone management held a conference call with EnCap to discuss Lodzinski's proposed combination of Earthstone and Bold. Lodzinski's team expressed their view that a combination could be beneficial to both parties, and committed to immediately begin a comprehensive review of Bold's assets.

66. Two days later, on November 19, 2015, Lodzinski's team caused Earthstone to enter into a confidentiality agreement with EnCap to govern the exchange of information concerning Bold. Throughout late November and early December 2015, EnCap provided Earthstone management with information concerning Bold, including access to the data room created by TPH during the prior summer's marketing process.

67. On December 7, 2015, Lodzinski and Earthstone management held an initial conversation with TPH regarding Bold. That same day, Earthstone

personnel including technical employees, met with a representative of the petroleum engineering firm W.D. Van Gonten & Co. to discuss technical subjects pertaining to Bold's assets. The next day, December 8, 2015, Lodzinski's team caused Earthstone to enter into a confidentiality agreement with Bold in order for Earthstone to review technical, operational, financial and analytic information prepared by Bold and TPH in the course of their marketing efforts. Then, on December 10, 2015, TPH presented a technical overview of Bold's assets to Earthstone and EnCap. On December 18, 2015, a follow-up meeting was held at which TPH, Earthstone, and EnCap again discussed Bold's assets, including land and infrastructure issues and a development model for the properties.

68. From mid-December 2015 through mid-January 2016, Lodzinski's team met with three separate investment banking firms to solicit their views on valuation parameters related to Bold's assets, methods to fund their development, and equity market receptivity to the potential acquisition of Bold's assets.

69. But deteriorating conditions in the oil and gas industry brought deal discussions to a temporary halt. In mid-January 2016, the price of oil hit a 12-year low. At a January 19, 2016 meeting, Earthstone and EnCap determined to defer their pursuit of an Earthstone–Bold combination to a later date in view of the deteriorating market conditions, including the downward pressure on oil prices and the equity markets being unreceptive to the industry. On January 21, 2016,

Earthstone and Bold management confirmed that discussions should be placed on hold due to market conditions.

70. From the time Lodzinski made his initial overture to EnCap in November 2015, through the decision in January 2016 to put the deal “on hold,” Lodzinski never informed the Earthstone Board that he was pursuing a potential combination of Earthstone and Bold. In view of the myriad conflicts of interest presented by a combination of two EnCap affiliates – *i.e.*, Earthstone and Bold – it was incumbent upon Lodzinski to go to the Board before taking any significant step toward such a transaction. Instead, as explained above, Lodzinski made his initial proposal without the Board’s knowledge or approval. He then entered the Company into a series of confidentiality agreements and undertook due diligence without the Board’s knowledge or approval. He likewise decided to put the deal “on hold” without the Board’s knowledge or approval.

D. Lodzinski Reengages With EnCap and Informs the Earthstone Board of His Intent to Make an Offer for Bold, But the Board Fails to Deliberate or Exercise Any Oversight

71. By April 2016, conditions in the oil and gas industry had started to improve and Lodzinski was ready to move forward with a combination of Earthstone and Bold. Intending to move quickly to make an offer, Lodzinski presumably now realized he could no longer keep the rest of the Board entirely in the dark. On April 27, 2016, despite having made his initial overture to EnCap and

Bold approximately six months earlier (*i.e.*, in November 2015), Lodzinski finally informed the Board of a potential deal involving Bold. Lodzinski informed the Board through an eight-page letter intended to provide “a comprehensive status update” on Earthstone’s operations in advance of the Board’s regularly-scheduled May 3, 2016 meeting.

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

73. Lodzinski did not wait for the Board’s input before reengaging with EnCap. On April 29, 2016, days before the May 3 Board meeting, Lodzinski and his Earthstone management team reconvened with EnCap to discuss moving forward with the potential combination.

74. The Board finally met on May 3, 2016. The meeting was attended by the full Board, including Directors Lodzinski, Singleton, Zorich, Swanson, Thielemann, Urban, and Joliat, as well as two members of Lodzinski’s management team, EVP for Engineering and Corporate Development Robert J. Anderson and VP for Finance and Treasurer Neil K. Cohen (“Cohen”). Characteristic of Earthstone’s close relationship with EnCap and casual disregard

for corporate formalities between the two entities, *the meeting was held at EnCap's office in Houston, Texas* and was attended by two EnCap associates, Bryan Stahl and Jason Hajdik.

75. Very little of the meeting concerned Lodzinski's intention to have Earthstone make an offer to EnCap for Bold. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

76. Although Lodzinski apparently downplayed information concerning a potential combination of Earthstone and Bold in the materials presented to the Board, the Board's failure to scrutinize Lodzinski's proposal is inexcusable. The Board knew that the Company's Chairman and CEO, Lodzinski, was personally beholden to Earthstone's (and Bold's) controlling stockholder, EnCap. The Board knew that most of its own members were also personally beholden to EnCap. The Board knew, assuming its members actually reviewed the materials presented to it in connection with the meeting, that Lodzinski intended to make an offer to EnCap for Bold or its assets. Any properly functioning Board faced with these circumstances would have immediately sought to manage the pervasive conflicts of interest inherent in such a proposal and exercise oversight over any ongoing negotiations. Instead, the Earthstone Board was content not to discuss the proposal at all, or, at most, to briefly discuss the proposal as part of a discussion on "Corporate and asset acquisition opportunities" generally – while sitting in EnCap's offices and in the presence of EnCap employees.

E. The Board Continues To Sit Idle While Lodzinski Negotiates With EnCap and Bold Concerning a Potential Transaction

77. Shortly after the May 3 Board meeting, with the Board having missed its opportunity to manage or mitigate the pervasive conflicts of interest and to otherwise ensure independent oversight of the process, Lodzinski made his

opening bid for Bold. On May 11, 2016, without having retained any independent 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 common stock. EnCap indicated it would review Earthstone's valuations with TPH.

78. 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. Although the reasons for this quick upward adjustment are not clear, the Proxy reports that "[t]he increase in valuation over the presentation materials provided on May 11, 2016 was largely attributable to the inclusion of acreage that had been recently acquired by Bold that was not included in Earthstone's prior valuation"¹⁵

79. Then, on May 23, 2016, Earthstone engaged in additional communications with EnCap and TPH concerning a potential transaction and provided TPH access to its corporate data room, which included Earthstone management's combined corporate model of Earthstone and Bold as well as a model of Earthstone's net asset valuation.

80. On June 2, 2016, Earthstone EVP for Engineering and Corporate Development Robert J. Anderson ("Anderson") discussed Bold's assets with

¹⁵ Proxy at 47.

Bold's President, Joseph L. Castillo ("Castillo") and, as a result of their discussion, the two executives agreed to set up an in-person meeting. The next day, June 3, 2016, Earthstone met with TPH to discuss the current asset and divestiture market for transactions in markets relevant to a possible Earthstone – Bold transaction, including the Midland Basin and Eagle Ford areas of Texas. Later that same day, EnCap Managing Director and Earthstone director Thielemann sent an email to Lodzinski and Anderson providing "a suggested action plan to be carried out over the ensuing weeks and months, relating to a possible transaction between [Earthstone and Bold] ..."¹⁶ EnCap and Earthstone then held a teleconference on June 7, 2016 concerning the plan of action outlined in Thielemann's email.

81. Moving quickly towards a final transaction, Lodzinski and Anderson met with Castillo twice on June 10, 2016. First, the three met at Earthstone's office for a meeting concerning the proposed combination. They also met at EnCap's offices for a meeting with EnCap and TPH, at which TPH provided its views on the equity market's likely receptivity to a combination of Earthstone and Bold.

82. On June 21, 2016, Anderson and Castillo emailed to arrange a meeting to begin a due diligence review that would include an overview of the assets of both companies and a tour of Bold's field facilities. On June 27, 2016,

¹⁶ Proxy at 48. The Proxy discloses the existence of Mr. Thielemann's email but does not further describe his suggested "action plan."

members of Earthstone's and Bold's management teams met in Midland, Texas to review Bold's assets in further detail. The next day, June 28, 2016, operational employees of Earthstone conducted a field visit to certain of Bold's properties, including horizontal well locations and facilities in Upton, Reagan, and Midland counties, Texas. Also on June 28, 2016, Earthstone provided Bold access to its corporate data room.

83. On July 6, 2016, Earthstone management, EnCap, and EnCap's counsel held a meeting at EnCap's offices. According to the Proxy, "[t]he purpose of the meeting was to develop a preliminary timeline to complete a possible transaction, identify the participants and their counsel, and assign responsibilities to complete the proposed transaction."¹⁷

84. Throughout May, June, and early July, the Earthstone Board – including its purportedly independent directors – sat idly as Lodzinski worked to put his proposed Earthstone – Bold combination on a downhill track to a definitive agreement. Lodzinski had made two pitches to EnCap for Bold arriving at valuations without the input or advice of an independent financial advisor or Board input, engaged in extensive negotiations and two-way diligence (including granting Bold access to confidential Earthstone financial information), and even arranged for Earthstone and Bold employees to begin touring each other's facilities.

¹⁷ Proxy at 48.

Meanwhile, the Earthstone Board sat idle.

F. After Lodzinski Makes Multiple Pitches To EnCap For Bold, Earthstone's Conflicted Directors Attempt To Retrace Their Steps And Belatedly Form A Special Committee

85. It was not until July 8, 2016 that Earthstone's purportedly independent directors, Joliat and Urban, began taking steps to form a special committee. As an initial matter, neither director was independent for purposes of overseeing Lodzinski's proposed combination of Earthstone and Bold.

86. Urban has a longstanding relationship with Lodzinski. Urban currently serves as CEO of the Vlastic Group, a private investment company that serves the interests of the Vlastic family. The Vlastic family has backed five different Lodzinski companies dating back to 1988.¹⁸

87. Moreover, both Joliat and Urban hold membership interests in Oak Valley and joined the Earthstone Board as part of the slate that took over in December 2014 after the Reverse Merger. Joliat's and Urban's longstanding relationship with Lodzinski, which pre-dates their service on the Earthstone Board, disqualified them from independently overseeing Lodzinski's attempt to combine Earthstone and Bold. Nevertheless, as the Company's purportedly independent directors, the task of forming a special committee fell to them.

¹⁸ Toby Shute, *Oil Patch Quick Pitch: GeoResources*, The Motley Fool (Sept. 16, 2010), <https://www.fool.com/investing/general/2010/09/16/oil-patch-quick-pitch-georesources.aspx>.

88. On July 8, 2016, presumably realizing they had dropped the ball by failing to exercise oversight earlier, Joliat and Urban held a conference call with Earthstone management and Earthstone's legal counsel during which Joliat and Urban expressed their intention to form a special committee to oversee a potential combination of Earthstone and Bold. Over the course of the following week, Joliat and Urban interviewed potential legal counsel, ultimately retaining Richards, Layton, & Finger, P.A. ("RLF").

89. Meanwhile, Earthstone management continued to negotiate the details of the proposed transaction, including sensitive details such as the management of the resulting entity. On July 12, 2016, while the Special Committee was still interviewing potential counsel, Lodzinski met with Bold's Chief Financial Officer James R. Lawrence ("Lawrence") and EVP for Business Development David L. Cox ("Cox") to discuss, among other things, employee matters and the future composition of Earthstone's board of directors.

90. Although the full Earthstone Board did not pass a resolution forming the Special Committee until July 29, 2016, Joliat and Urban began holding *de facto* Special Committee meetings on July 19, 2016. That day, the *de facto* Special Committee members held a meeting at which they were joined by their counsel from RLF, as well as counsel for the Company from Jones & Keller ("J&K").



[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] Meanwhile, that same day,

operational employees of Earthstone were meeting with technical employees of Bold and visiting Bold's then-current drilling location in the Midland Basin to review Bold's overall drilling and completion practices and techniques.

91. The Special Committee was belatedly parachuting into a transaction already rapidly coming together without their involvement. Their untimely attempt to retrofit a special committee process into already mature negotiations was a quintessential example of "too little, too late." [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

94. But it was far too late for any of that to be true. Significant negotiations had already occurred, and major steps – including Earthstone’s initial bids for Bold – had already been made, all without any involvement of the Special Committee. Those prior negotiations and decisions undoubtedly constrained the Special Committee’s ability to direct the process going forward. [REDACTED]

[REDACTED]

[REDACTED] Lodzinski had

controlled the entire process to date and formulated the initial bids that would tie

the Special Committee's hands on price going forward.

[REDACTED]

96. While the Special Committee had just been formed and was trying to get up to speed, Earthstone management had already evaluated and prepared valuations for Bold's assets, made plans for integrating those assets into

Earthstone's business and presented its valuations to EnCap. Lodzinski and his team had also worked with EnCap to formulate a timeline for diligence and negotiations, engaged in extensive two-way diligence with Bold and EnCap, begun discussing specific transaction structures and begun working with EnCap's counsel on side-agreements to lessen the tax burden of the eventual transaction. They had also engaged in discussions with Bold and EnCap concerning management of the entity that would result from the proposed combination.

G. The Special Committee Allows Lodzinski to Continue Dictating The Process

97. From the time it was formed, the Special Committee was boxed-in and hamstrung by Lodzinski's prior proposals to and negotiations with EnCap and Bold. EnCap and Bold had not conditioned any offers on majority, disinterested stockholder approval, and the Special Committee never was able to negotiate such a condition from the outset given its delayed formation. The Special Committee also failed to protect minority stockholders' interests in other ways. For example, it continued to allow Lodzinski to control negotiations, even rubber-stamping concessions Lodzinski made to Bold that contravened the Special Committee's express instructions and the advice of the Special Committee's financial advisor.

98. After hearing Lodzinski and Anderson's presentation on July 22, the Special Committee determined to hire its own financial advisor, ultimately selecting Stephens. On August 3, 2016, the Special Committee and its legal

counsel from RLF held an initial meeting with Stephens bankers Kerry North (“North”) and Keith Behrens (“Behrens”). [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] [REDACTED] [REDACTED] [REDACTED] [REDACTED] [REDACTED] [REDACTED]

[REDACTED]

99. Meanwhile, Lodzinski and his team continued charging ahead at full speed. On August 10, 2016, the full Earthstone Board held an in-person meeting (with Joliat and Urban participating telephonically) [REDACTED]

[REDACTED]

[REDACTED] Remarkably, this meeting was *held at EnCap’s offices in Houston, Texas and was attended by two EnCap employees, Stahl and Hajdik.*

100. On August 16, 2016, Stephens was finally prepared to offer its preliminary financial analysis to the Special Committee. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

101. Although Behrens indicated that Stephens's preliminary analysis suggested a total valuation for Bold in excess of \$325 million, his presentation drew attention to certain red flags concerning the deal. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

102. Another red flag concerned the valuation of the Company's own stock. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

103. The Special Committee met with Earthstone management later on August 16 to discuss those issues. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] The Special Committee then authorized Lodzinski to send an offer letter to Bold.

105. Lodzinski proceeded to submit an offer letter to Bold proposing a transaction whereby Earthstone would combine with Bold in an all-stock transaction valuing Bold at \$325 million, including the assumption of net financial obligations not to exceed \$25 million. The \$325 million figure hewed close to Lodzinski's \$335 million pitch to EnCap on May 18, perhaps unsurprisingly given Stephens' reliance on Earthstone management's projections. The number of Earthstone shares to be issued, according to the offer letter, would be calculated by dividing \$325 million, less net financial obligations, by the greater of (i) Earthstone's volume-weighted average share price for the twenty (20) trading days preceding the date a definitive agreement is signed, or (ii) \$10.50 per share. Assuming approximately \$25 million in net financial obligations and a \$10.50 share price, the offer letter contemplated Earthstone owning approximately 45% of the resulting entity.

106. Shortly thereafter, the final negotiations between Earthstone and Bold began. The Special Committee, either ignoring or blind to the blatant conflict created by Lodzinski's involvement, permitted Lodzinski to continue serving as Earthstone's lead negotiator. On August 24, 2016, Lodzinski met with Castillo to begin more detailed negotiations on the broader terms of the proposed transaction with, as the Proxy reports, those discussions having a particular focus on "Earthstone's proposed relative valuation." A week later, Castillo sent Lodzinski

Bold's counterproposal, which called for Bold to own 65.5% of the combined entity.

107. The Special Committee then held meetings with RLF, Stephens, and members of Management on September 1 and September 6, 2016 to consider Bold's counterproposal. [REDACTED]

[REDACTED] The Special Committee met again on the morning of September 8, 2016, this time only with counsel from RLF and Lodzinski. After a brief discussion, the Special Committee authorized Lodzinski to make a counteroffer whereby Bold would receive 60% ownership (in the form of 34.593 million shares of Earthstone common stock) in the combined company. Lodzinski then submitted that offer in writing to Castillo.

H. Lodzinski And Management Tell The Special Committee To Accept A Transaction That Provides For "Slightly Less Than A 40% Ownership Interest", And Stephens Reverses Course, Informing The Special Committee It Can Now Provide A Fairness Opinion Even "[I]f the Company's ownership percentage is slightly below 40%"

108. [REDACTED]

109. On September 9, 2016, Castillo responded to Earthstone's

counteroffer with a letter to Lodzinski reiterating his position that Bold should have 62.5% ownership of the combined Company. Then, on September 12, 2016, Lodzinski and Castillo held a discussion by phone concerning Earthstone's counteroffer and Bold's response. On that call, [REDACTED]

[REDACTED] Lodzinski stated to Castillo that Earthstone might be able to increase its proposal from 34.593 million shares of Earthstone common stock to 35.5 million shares of Earthstone common stock – which would, on the terms of Earthstone's counteroffer, increase Bold's projected ownership interest to more than 61.5%. Castillo agreed to consider the proposal and Lodzinski stated he would seek further direction from the Special Committee.

110. The next day, September 13, 2016, the Special Committee held a meeting with its advisors from RLF and Stephens. [REDACTED]

[REDACTED]

I. The Special Committee Inappropriately Permits Lodzinski To Speak Directly With Stephens Regarding Valuation

112. During the September 13 meeting, the Special Committee exacerbated their continued failure to manage Lodzinski's conflicts [REDACTED]

[REDACTED]

[REDACTED]

113. Despite the clear mandate of the Special Committee to wall-off

interested directors and executives, Lodzinski signaled his willingness to drop Earthstone's ownership below the 40% threshold the very next time he communicated with Castillo. On September 19, 2016, Lodzinski agreed to propose to the Special Committee, and Castillo agreed to propose to EnCap, a transaction whereby Bold would receive 36.0 million shares of Earthstone common stock, or a 61% ownership of the combined company. Further, Lodzinski agreed to request authority from the Special Committee to increase the offer to 36.5 million shares of Earthstone common stock, or a 61.3% ownership, of the combined company if necessary to come to a final agreement on the transaction consideration.

114. Lodzinski informed the Special Committee of his agreement with Castillo during a Special Committee meeting on September 23, 2016, at which RLF, J&K, and other members of Earthstone management were also present. [REDACTED]

[illegible]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

115. At this critical juncture in the negotiations, the Special Committee failed to push back on Lodzinski and hold the line on its 40% ownership requirement. Until this meeting, the Special Committee's principal concern had been ensuring that Earthstone ended up with a 40% or greater ownership interest in the combined entity, and the Committee had repeatedly instructed Lodzinski to that effect. When Lodzinski contravened that instruction and requested the Special Committee's authorization to finalize a transaction at less than 39%, however, the Special Committee capitulated within minutes and without even seeking analysis on Lodzinski's proposal from Stephens. In doing so, the Special Committee failed to advance the interests of Earthstone's minority stockholders and, instead, once again deferred to the Company's conflicted Chairman and CEO, and their own longtime business associate, Lodzinski.

116. After the Special Committee authorized Lodzinski to offer up to 61.3% of the combined company to Bold, negotiations proceeded quickly to a final agreement. Notably, on October 4, 2016, Lodzinski and Anderson met with Castillo, Cox, and Lawrence to discuss "employee matters" and other transaction

details. Then, on October 27, 2016, Lodzinski, Anderson, Castillo, Cox, and Lawrence met with Thielemann, Stahl, Hajdik, and Burroughs from EnCap to further discuss various contractual matters. The Proxy discloses that sometime during “late October” and “early November 2016,” these “various contractual matters” included, among other things, “The Voting and Support Agreement” and “The Voting Agreement.”

J. The Conflicted Special Committee and Board Approve The Transaction Then Simultaneously Approve Voting Agreements Securing Their Post-Transaction Directorships

117. By November 7, 2016, Earthstone and Bold had reached agreement on a structure for the proposed transaction. As Lodzinski had suggested during his initial presentation to the Special Committee in July 2016, the deal would take the form of an “Up-C” transaction proceeding in several steps. *First*, Earthstone would recapitalize its common stock into two classes, A and B, with all of Earthstone’s existing common stock to be converted into Class A common stock. EnCap and its affiliates controlling Bold would contribute their ownership interests in Bold to a newly-formed vehicle, Bold Holdings, which would then purchase 36,070,828 shares of Earthstone Class B common stock for nominal consideration. As additional consideration, 150,000 shares of Class A common stock would be issued to certain members of Bold. *Second*, a newly-formed Delaware limited liability company and wholly-owned subsidiary of Earthstone, EEH, would issue

22,289,177 units to Earthstone in exchange for all of Earthstone's assets and 36,070,828 units to Bold Holdings in exchange for all of Bold's assets. Upon closing of the transaction, Earthstone would conduct its business through EEH and be its sole managing member, with current Earthstone stockholders and Bold Holdings owning approximately 39% and 61% of the combined company's Class A common stock, respectively. The deal would be memorialized by a "Contribution Agreement" and a series of ancillary agreements, with closing conditioned on a majority vote of Earthstone's disinterested stockholders (*i.e.* stockholders other than Oak Valley and management).

118. That same day, the Special Committee met to approve the proposed transaction. The Special Committee was joined by, *inter alia*, Lodzinski, Anderson, and Singleton. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] Importantly, Stephens' analysis was based on Earthstone management's overly-bullish projections concerning Bold's assets and the share of Bold's "probable reserves" that would prove productive.

120. The Committee's advisers from Stephens then departed the meeting and, shortly thereafter, the Special Committee unanimously adopted resolutions recommending approval of the proposed transaction, including the Contribution Agreement and ancillary agreements.

121. Later on November 7, 2016, the full Earthstone Board met telephonically and, after hearing the Special Committee's recommendation, unanimously approved the proposed transaction, including the Contribution Agreement and ancillary agreements.

122. In addition to approving the Contribution Agreement, as part of the

“ancillary agreements” that were approved, the Special Committee and Board also agreed to enter into a Voting Agreement with EnCap, Bold and Oak Valley. The Voting Agreement preserved the directorships of the Director Defendants post-closing and provided EnCap the right to replace one director at any time its ownership of Earthstone exceeds 50% of the outstanding common stock.

123. In other words, in exchange for approving the Transaction, the entire Earthstone Board will be members of the new post-transaction entity, as demonstrated below from page 102 of the Proxy:

Table of Contents			
MANAGEMENT FOLLOWING THE COMPLETION OF THE TRANSACTION			
Pursuant to the terms of the Voting Agreement to be entered into at the closing of the Transaction, the board of directors will consist of nine members, four of which shall be designated by EnCap, three of which shall be independent, and two of which shall be members of Earthstones management, including our Chief Executive Officer.			
The following table lists the names and ages as of April 6, 2017 and positions of the individuals who are expected to serve as directors upon completion of the Transaction.			
Name	Director Since	Age	Position with Earthstone
Frank A. Lodzinski	2014	67	Chairman of the Board, President and Chief Executive Officer
Jay F. Joliat	2014	60	Director
Phil D. Kramer	2016	60	Director
Douglas E. Swanson, Jr.	2014	45	Director
Ray Singleton	1989	66	Director and Executive Vice President, Northern Region
Brad A. Thielemann	2014	40	Director
Zachary G. Urban	2014	39	Director
Robert L. Zorich	2014	67	Director

K. The Transaction Is Grossly Unfair

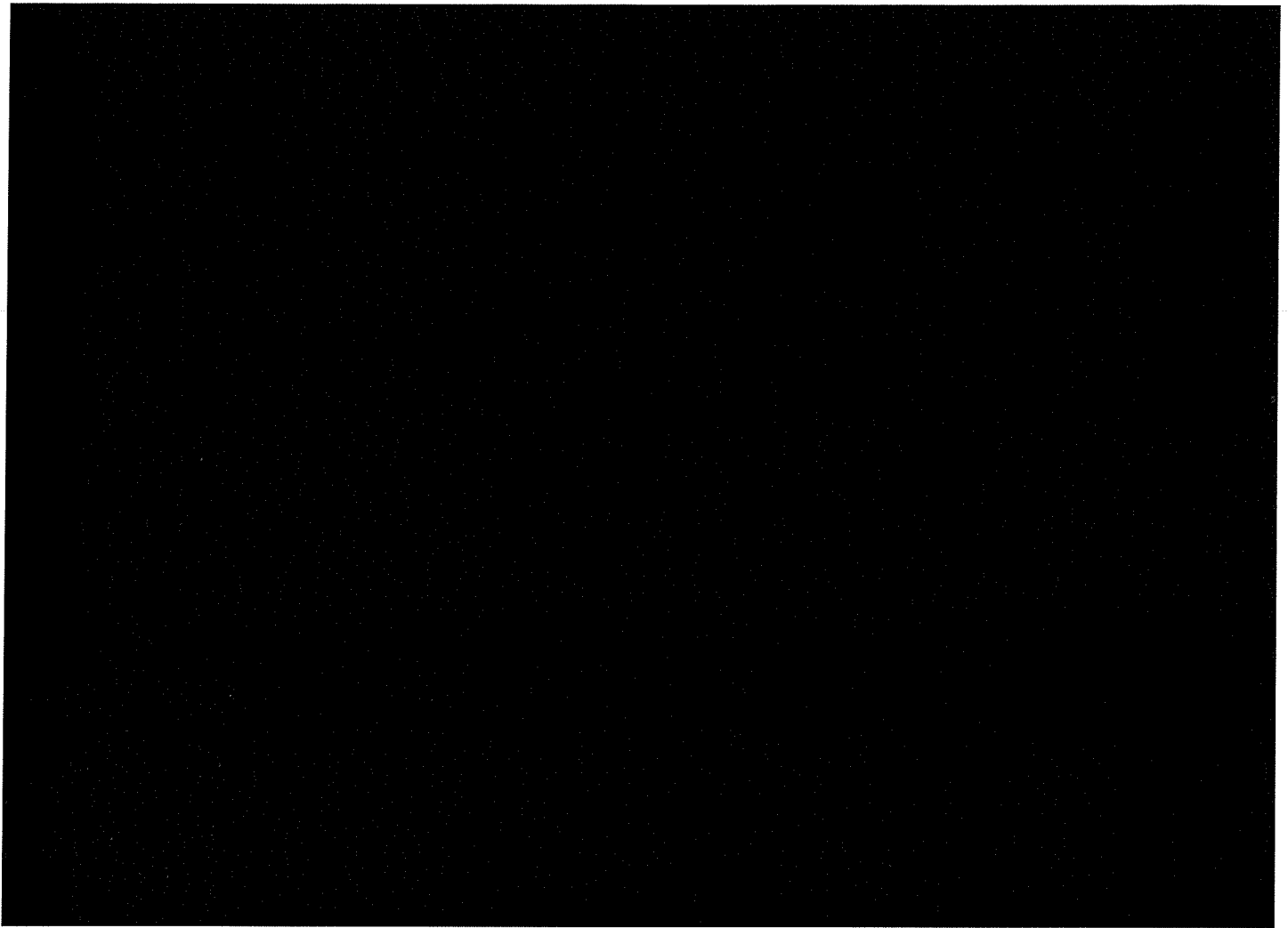
124. The consideration Earthstone and its stockholders received in the Transaction is grossly unfair and drastically undervalued Earthstone in at least two material ways.

1. Stephens Tells The Special Committee Its Initial Contribution Analysis Does Not Support A 60-40 Split, So The Special

Committee, Management And Stephens Fix The Numbers

125.

60



[Redacted line of text]

[Redacted line of text]

[Redacted line of text]

[Redacted line of text]

[Redacted line of text]

127. [Redacted line of text]

[Redacted line of text]

[Redacted line of text]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

2. Earthstone's Stock Price Skyrocketed, Confirming Stephens'

Advice To The Special Committee That Earthstone's Stock Price Was "Undervalued"

129. Between November 7, 2016 and April 7, 2017, Earthstone's stock price increased dramatically from \$8.98 per share to \$14.98 per share. The substantial resultant increase in Earthstone's market capitalization underscored and enhanced the unfairness of the Transaction to the Company and its stockholders.

Shares Outstanding	22.3 million
Earthstone's Market Capitalization <u>Calculated by Stephens</u> (as of November 7, 2016 fairness opinion) [ESTE000523].	~\$189.2 million
Earthstone's Share price (as of November 4, 2016)	\$8.49 per share
<i>Earthstone's Market Capitalization (as of April 7, 2017)</i>	<i>~\$334 million</i>
Earthstone's Share Price (as of April 7, 2017)	\$14.98 per share

130. [REDACTED]

[REDACTED]
[REDACTED] the Special Committee still failed to secure a collar or
a walk-away right to protect stockholders and the Company. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

131. The Special Committee was also aware that the Company's stock price was highly volatile due to commodity pricing and that within its public filings the Company affirmatively warned investors of this very fact. As the Proxy discloses:

The number of shares of Class B Common Stock to be issued to Bold Holdings is fixed and will not be adjusted in the event of any change in Earthstone's stock price This share amount was fixed in the Contribution Agreement and will not be adjusted to reflect changes in the market price of our Common Stock before the Transaction is completed.¹⁹

132. Earthstone's public filings over the past two years demonstrate that the Company and Special Committee were aware of the volatility in Earthstone's stock price and repeatedly warned stockholders about this risk:

¹⁹ Proxy at 25.

- *Oil, natural gas and natural gas liquids prices have been historically volatile.* Their prices since 2014 have adversely affected, and may continue to adversely affect, our business, financial condition and results of operations and may in the future affect our ability to meet our financial commitments as well as negatively impact our stock price.²⁰

* * * *

Our common stock price has been and may continue to be highly volatile.

- *Commodity Price Risk, Derivative Instruments and Hedging Activity*

We are exposed to various risks including energy commodity price risk. When oil, natural gas, and natural gas liquids prices decline significantly our ability to finance our capital budget and operations may be adversely impacted. *We expect energy prices to remain volatile and unpredictable.*²¹

133. A well-functioning and independent Special Committee would have recognized the need to re-evaluate the Transaction in light of Earthstone's increased stock price, potentially resulting in Earthstone and stockholders receiving a larger portion of the post-Transaction entity. Bold was not a publicly-traded company; thus, it was not subject to the same market price fluctuations and volatility as Earthstone. That is, because Earthstone and Bold are both in the same

²⁰ 2016 Annual 10-K at 17, 28 (filed Mar. 15, 2017).

²¹ 10-Q at 33 (filed Nov. 8, 2016)(emphasis added); *see also* 10-Q at 22 (filed May 14, 2015)(“We seek to reduce our sensitivity to oil and natural gas price volatility and secure favorable debt financing terms by entering into commodity derivative transactions.”); 10-K at 22 (filed Mar. 27, 2015)(“Our common stock price has been and is likely to continue to be highly volatile.”).

upstream space, if Bold was publicly traded, the values of Earthstone and Bold would *both* rise and fall together based on market pressures and commodity prices. For instance, if the stock price of Earthstone went up due to rising oil prices, the value of Bold would also likely go up as well, and the relative valuation would stay the same. Here, by contrast, only Earthstone's stock had a price that was subject to market movement. These were not two public companies – thus, changes in Earthstone's stock price were, in an important sense, a one-sided risk.

134. Despite the dramatic increase in Earthstone's stock price and corresponding increase in the value of the deal consideration given to EnCap and Oak Valley, the Special Committee did not even discuss whether to renegotiate with EnCap. Indeed, according to the documents produced in response to Plaintiff's Section 220 Demand, the Special Committee did not even contemplate revisiting the issue to assess the dramatically changed circumstances.

L. The Control Group Defendants Are Legally-Affiliated Controlling Stockholders Of Earthstone

135. As discussed herein and as detailed further below, EnCap and Oak Valley acted as a "control group," implicating the entire fairness standard when they caused the Earthstone Board to enter into the Contribution Agreement with EnCap and Bold on terms that were not fair to Earthstone and its public stockholders.

1. EnCap Controlled A Majority Of Earthstone's Common Stock

Until Mid-June 2016

136. As described in sections IV(A) - (B), *supra*, from the end of December 2014 through sometime in mid-June 2016, EnCap owned and controlled a majority of Earthstone's outstanding common stock, as reported in the Company's public filings.

2. The Director Defendants, Oak Valley and EnCap Each Committed To Executing The Voting Agreement

137. In connection with executing the Contribution Agreement, the Special Committee and Board agreed to enter into a Voting Agreement with EnCap, Bold and Oak Valley pursuant to which those three entities agreed not to vote any of their shares of Class A Common Stock or Class B Common Stock in favor of any action that – or take any action that – would in any way alter the composition of the Earthstone Board from its composition immediately following the closing of the Transaction. In sum, every current member of the Earthstone Board – the same Board that approved the Transaction – would continue to serve on the post-Transaction board of directors.

M. Earthstone Files A Materially Deficient And Misleading Proxy

138. On April 7, 2017, compounding the unfairness of the process and the inadequacy of the consideration to be received by Earthstone's stockholders

through the Transaction, the Company filed a misleading Proxy that failed to disclose plainly material information necessary to permit Earthstone stockholders to decide on a fully-informed basis whether to vote in favor of the Transaction.

139. *First*, the Proxy failed to disclose that Stephens' initial contribution analysis did not support a 60/40 Bold–Earthstone split for the combined company, and that, as a result, the Special Committee, with management's assistance, manipulated Bold's and Earthstone's financial projections to make the consideration appear fair.

140. As detailed above,

[REDACTED]

141. Ultimately, Stephens and the Special Committee decided to include 2019 EBITDA in the contribution analysis to give the appearance that the consideration was fair even though doing so provided [REDACTED]. The Proxy omits this crucial information.

142. *Second,* [REDACTED]

[REDACTED]

[REDACTED]

143. Because Stephens' initial contribution analysis did not support a 60/40 Bold-Earthstone split, Stephens redirected the Special Committee's focus to another aspect of its financial analysis: the relative equity value analysis. Specifically, [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

146. This omitted information was critical to Earthstone stockholders' assessment of the Transaction, given that the Special Committee manipulated the contribution analysis by adding 2019 EBITDA projections. Instead of disclosing Stephens' doubts in providing a fairness opinion *before* the closing of the Transaction, the Proxy touted the fairness of the Transaction and made the misleading partial disclosure that "[a]fter careful consideration, our board of directors has unanimously . . . determined that the Contribution Agreement, the transactions contemplated thereby and the Transaction are fair, from a financial point of view, to our stockholders and are in the best interests of Earthstone."²²

147. *Third*, the Proxy failed to disclose that [REDACTED]

[REDACTED]

²² Proxy at 6.

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] Ultimately, however, the Special Committee's improper willingness to permit Lodzinski to directly communicate with Stephens concerning valuation resulted in Earthstone receiving a 39% ownership stake in the post-transaction entity.

148. The omission of Lodzinski's direct and inappropriate communications with Stephens concerning valuation is highly material. A 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 on whether to approve a transaction. Thus, it is imperative for the stockholders to be able to understand what factors might influence the financial advisor's analytical efforts.

149. Before stockholders can have confidence in a fairness opinion or rely upon it to an appropriate extent, the conflicts and arguably perverse incentives that may influence the financial advisor in the exercise of its judgment and discretion must be fully and fairly disclosed.

150. *Fourth*, the Proxy omitted any disclosure regarding the facts that

[REDACTED]

[REDACTED]

[REDACTED] [REDACTED] [REDACTED] [REDACTED] [REDACTED] [REDACTED] [REDACTED] [REDACTED] [REDACTED] [REDACTED] [REDACTED]

[REDACTED] As Earthstone's controlling stockholder, EnCap's motivation and unique incentives for orchestrating and entering into the Transaction are critical to stockholders' decision on whether to approve the Transaction. Instead of disclosing EnCap's true incentive for entering into the Transaction, the Proxy touted the Transaction's fairness by disclosing that "The Earthstone board of directors determined that the Contribution Agreement and the transactions contemplated by the Contribution Agreement are fair to, and in the best interests of Earthstone and its stockholders."²³ Without knowing EnCap's incentive for entering into the Transaction, stockholders were flying blind and unable to adequately assess the fairness of the Transaction consideration.

151. Particularly when viewed in conjunction with the allegations set forth herein, each of these disclosure deficiencies assumes heightened importance and materiality due to, *inter alia*, (a) the related-party nature of the Transaction; (b) the Control Group Defendants' significant influence over the Company and its stockholders; (c) the disproportionate benefits the Control Group Defendants received through the Transaction by virtue of their ownership of Bold; and (d) the massive dilution incurred from the perspective of Earthstone's non-EnCap

²³ Proxy at 54.

stockholders.

IV. CLASS ACTION ALLEGATIONS

152. Plaintiff brings this action pursuant to Rule 23 of the Rules of the Court of Chancery, individually and on behalf of all other holders of Earthstone common stock up to March 13, 2017 (except any Defendants herein and any persons, firm, trust, corporation or other entity related to or affiliated with them and/or their successors in interest) who were injured because of Defendants' wrongful actions, as more fully described herein (the "Class").

153. This action is properly maintainable as a class action.

154. The Class is so numerous that joinder of all members is impracticable. As of March 9, 2017, there were 22,273,820 shares of Earthstone stock issued and outstanding. Thus, upon information and belief, there were hundreds – if not thousands – of Earthstone stockholders scattered throughout the United States.

155. There are questions of law and fact common to the Class, including, *inter alia*, whether:

- a. The Director Defendants breached their fiduciary duties;
- b. The Control Group Defendants breached their fiduciary duties as controlling stockholders of the Company;
- c. Defendant Lodzinski breached his fiduciary duties as a director and officer of the Company;
- d. Defendant Bold aided and abetted the Control Group and the Director Defendants' breaches of fiduciary duty; and

- e. Plaintiff and the other members of the Class were injured by the wrongful conduct alleged herein and, if so, what is the proper measure of damages.

156. Plaintiff is committed to prosecuting the action and has retained competent counsel experienced in litigation of this nature. Plaintiff's claims are typical of the claims of the other members of the Class, and Plaintiff has the same interests as the other members of the Class. Plaintiff is an adequate representative of the Class.

157. Further, the prosecution of separate actions by individual members of the Class would create the risk of inconsistent or varying adjudications with respect to individual members of the Class that would establish incompatible standards of conduct for Defendants or adjudications with respect to individual members of the Class that would as a practical matter be disjunctive of the interests of the other members not party to the adjudications or substantially impair or impede their ability to protect their interests.

V. DERIVATIVE ALLEGATIONS

158. Plaintiff also brings this action derivatively to redress injuries suffered by the Company as a direct result of breaches of fiduciary duties by the Director Defendants and the Control Group Defendants, and alternatively, the Control Group Defendants' aiding and abetting of those breaches.

159. Plaintiff currently is a record owner of Earthstone common stock and

has owned Earthstone common stock continuously during the relevant time period.

160. Plaintiff will adequately and fairly represent the interests of Earthstone and its stockholders in enforcing and prosecuting their rights, and have retained counsel competent and experienced in stockholder derivative litigation.

VI. DEMAND ON THE EARTHSTONE BOARD IS EXCUSED AS FUTILE

161. Plaintiff repeats and realleges each and every allegation above as if set forth in full herein.

162. Plaintiff has not made a demand on Earthstone's current nine-member Board (the "Demand Board")²⁴ to investigate or initiate the claims asserted herein because demand is excused as futile.

163. Such demand would be futile and useless, and is thereby excused, for at least three independent reasons: (a) a majority of the Demand Board is either interested in the Transaction and/or lacks independence from EnCap, the Bold Defendants and/or Oak Valley, each of which was interested in the Transaction; (b) the Transaction is subject to entire fairness review; and (c) the Transaction was not the product of a valid exercise of business judgment.

A. A Majority Of The Members Of The Demand Board Were

²⁴ The Demand Board consists of all Director Defendants (as defined herein) as well as Wynne M. Snoots ("Snoots") who was appointed to the Earthstone board of directors on May 9, 2017.

Interested In The Transaction And/Or Lack Independence From The Control Group Defendants

164. **Defendant Lodzinski** cannot disinterestedly and independently consider a demand because he was interested in the Transaction and is beholden to the Control Group Defendants. Defendant Lodzinski is Earthstone's CEO, Chairman, and President and secured for himself continued employment as CEO, President and Chairman in the combined entity post-Transaction. As such, Earthstone concedes in its SEC filings that Lodzinski is not independent under the rules of the NYSE MKT.²⁵ Lodzinski was also interested because the Transaction will significantly increase the assets under his management. Further, EnCap is Oak Valley's largest investor and financial backer and has *de facto* control over Oak Valley and its Board of Managers, thus making Lodzinski beholden to EnCap. Lodzinski is beholden to the Control Group Defendants because they have been his primary source of capital since he founded Oak Valley in December 2012, and the Control Group Defendants have consistently provided financial backing for his endeavors. Indeed, as early as January 2014, Lodzinski touted his "long relationship" with EnCap. As described in section IV(A), *supra*, EnCap made its first investment in Oak Valley a week after Lodzinski founded it and was instrumental in getting Lodzinski's fledgling company off the ground. Since then, EnCap and its affiliated funds have consistently backed Lodzinski's strategic

²⁵ Earthstone Energy, Inc., Definitive Proxy, filed Oct. 4, 2016 at 6.

initiatives. Lodzinski is dependent on maintaining his relationship with EnCap for their continued support. Lodzinski also maintains a strong relationship with the Vlastic family, which also has strong ties to EnCap. The Vlastic family invested approximately \$20 million in Oak Valley and currently owns 400,000 units, yielding 7.5% voting interest in Oak Valley.²⁶ Additionally, because EnCap controls both Oak Valley and Earthstone, EnCap has the power to remove Lodzinski from his positions as Chairman, President, and CEO of the Company.

165. **Defendant Zorich** cannot disinterestedly and independently consider a demand because he was interested in the Transaction and is beholden to the Control Group Defendants. Zorich co-founded and is presently a Managing Partner of EnCap. As a result, he stood on both sides of the Transaction. Zorich's primary loyalties, moreover, rest with EnCap. Zorich joined the Earthstone Board in December 2014 in connection with the Reverse Merger by which EnCap assumed control of Earthstone. EnCap's website touts that Zorich "serves on the board of directors of several EnCap portfolio companies," of which Earthstone is only one.

166. **Defendant Swanson** cannot disinterestedly and independently

²⁶ In 1984, Lodzinski began rolling up failing oil drilling partnerships into Energy Resource Associates Inc., with financial backing of the Vlastic family. Nissa Darbonne, *Look Who's Doing It Again: Frank Lodzinski*, Oil and Gas Investor (June 23, 2014, 3:58 PM), <http://www.oilandgasinvestor.com/blog/look-whos-doing-it-again-frank-lodzinski-564526#p=full>.

consider a demand because he was interested in the Transaction and because he is beholden to the Control Group Defendants. Swanson is a Managing Partner of EnCap. As a result, he stood on both sides of the Transaction. Swanson's primary loyalties, moreover, rest with EnCap. Swanson joined the Earthstone Board in December 2014 in connection with the Reverse Merger by which EnCap assumed control of Earthstone. EnCap's website touts that Swanson "serves on the board of numerous independent exploration and production companies" in EnCap's portfolio of companies, of which Earthstone is only one.

167. **Defendant Thielemann** cannot disinterestedly and independently consider a demand because he both was interested in the Transaction and is beholden to the Control Group Defendants. Thielemann is a Managing Director of EnCap. As a result, he stood on both sides of the Transaction. Thielemann's primary loyalties, moreover, rest with EnCap. Thielemann joined the Earthstone Board in December 2014 in connection with the Reverse Merger by which EnCap assumed control of Earthstone. EnCap's website touts that Thielemann "serves on the board of directors of several EnCap portfolio companies," of which Earthstone is only one.

168. **Defendant Singleton** cannot disinterestedly and independently consider a demand because he is beholden to the Control Group Defendants. Defendant Singleton currently serves as a member of the Board and as Executive

Vice President for the Northern Region of the Company. Like Lodzinski, Singleton also secured for himself continued employment in the combined entity post-Transaction. As such, Earthstone concedes in its SEC filings that Singleton is not independent under the rules of the NYSE MKT.²⁷ Having joined Earthstone in 1988, Singleton has worked at Earthstone for decades. Further, based on Singleton's LinkedIn profile as of May 30, 2017,²⁸ his employment with Earthstone was his primary source of income over that time. As a Company executive, Singleton works for Lodzinski, who is beholden to EnCap. After EnCap and Lodzinski assumed control of Earthstone in December 2014, Singleton was the sole member of the previous board of directors who was permitted to stay on the Company's Board. In exchange for Singleton's loyalty to EnCap and Oak Valley, Singleton remains employed by Earthstone which according to Singleton's LinkedIn profile as of May 30, 2017, is his sole employer. As an executive of Earthstone, Singleton has received and continues to receive substantial monetary compensation. Specifically, in fiscal years 2016, 2015 and 2014, Singleton received compensation in the amount of \$1,017,754, \$244,283 and \$451,462, respectively. As an officer of Earthstone with post-Transaction employment, Singleton could not objectively consider a demand to investigate or prosecute

²⁷ Earthstone Energy, Inc., Definitive Proxy, filed Oct. 4, 2016 at 6.

²⁸ Ray Singleton, LinkedIn Profile, <https://www.linkedin.com/in/ray-singleton-a9a54345/> (last accessed May 30, 2017).

claims that could ultimately be adverse to EnCap's interests, such as the claims asserted herein.

169. **Defendants Joliat, Urban and Kramer** are similarly unable to act disinterestedly from the Control Group Defendants. Upon closing of the Transaction, each of Joliat, Urban and Kramer will continue to serve on the surviving entity's board of directors. As explained herein, the Special Committee and Board agreed to enter into the Voting Agreement that preserved the composition of Earthstone's Board. Additionally, Urban currently serves as the CEO of the Vlastic Group, a private investment company that serves the interests of the Vlastic family.²⁹ Since 1988, the Vlastic family has invested in at least five different Lodzinski-led companies.³⁰ Members of the Vlastic family have also served on the boards of other EnCap portfolio companies such as Halcón Resources Corporation. Additionally, Defendants Joliat and Urban have a longstanding relationship with Lodzinski, having invested in Oak Valley and only become associated with Earthstone as a result of its Reverse Merger with Oak Valley.

B. Demand Is Excused As A Matter Of Law Because The Transaction Is Subject To Entire Fairness

170. Demand is excused as a matter of law because Earthstone's entry into

²⁹ Vlastic Group has been the family's primary asset since it sold the Vlastic Food Company (Vlastic Pickles) in 1978 to Campbell Soup.

³⁰ See *supra* note 18.

the Transaction is subject to entire fairness review.

171. The Transaction is subject to entire fairness scrutiny for two independent reasons: (i) because the Control Group Defendants—Earthstone’s controlling stockholders—stood on both sides of the Transaction; and (ii) because, as detailed in the immediately preceding section, a majority of the members of the Board were either interested in the Transaction or otherwise not independent of the Control Group Defendants.

172. As detailed herein, the process leading to the Transaction was heavily-conflicted, fatally-flawed and did not adequately protect the Company and its minority stockholders from an abuse of power by the Control Group Defendants. As also detailed herein, the Special Committee and the Board were not adequately informed and/or failed to act honestly and in good faith in approving the Transaction.

173. For the reasons stated in Sections IV(A) - (B), (L) and VI(A), herein, the Control Group Defendants are the controlling stockholders of Earthstone.

C. The Transaction Was Not The Product Of A Valid Exercise Of Business Judgment

174. As detailed herein, the process leading to the Transaction was fatally flawed and heavily conflicted. The Special Committee and Board acted in bad faith and/or without adequate information in *inter alia*, (i) revising Stephens’ initial contribution analysis to include 2019 financial projections make the Transaction

appear fair, (ii) negotiating the Contribution Agreement without any walk-away right or collar on the shares to be issued in light of the dramatic increase in Earthstone's stock price and corresponding increase in the value of the consideration the Company contributed to EnCap and Bold, (iii) allowing Lodzinski to have direct communications with Stephens regarding valuation, (iv) failing to address the rampant conflicts plaguing the Transaction and the process that produced it, and (v) issuing the deficient Proxy.

175. Further, given the status of Bold's operations and EnCap's need for capital, the terms of the Transaction are so one-sided that they are beyond the bounds of reasonable judgment and are inexplicable on any ground other than bad faith.

176. Thus, demand on the Board is excused as futile.

COUNT I

DIRECT AND DERIVATIVE CLAIM FOR BREACH OF FIDUCIARY DUTY AGAINST THE DIRECTOR DEFENDANTS

177. Plaintiff repeats and realleges each and every allegation above as if set forth in full herein.

178. The Director Defendants, as Earthstone directors and officers, owe the Company and the Class the utmost fiduciary duties of due care, good faith, loyalty and disclosure.

179. The Director Defendants failed to fulfill their fiduciary duties in connection with the Transaction by (a) running an ill-timed and conflict-laden acquisition process, (b) failing to secure fair value in connection with the Transaction, and (c) failing to disclose all material information necessary to allow Earthstone stockholders to make an informed decision on whether to support the Transaction.

180. As a result of the Director Defendants' breaches of fiduciary duty, the members of the Class have been harmed by having their economic and voting power in the company unfairly reduced vis-à-vis the Control Group Defendants. Plaintiff and the Class have no adequate remedy at law for this harm.

181. As a result of the Director Defendants' breaches of fiduciary duty, the Company has been harmed as a result of the overpayment to EnCap and Bold. The Company has further been harmed by the new detrimental holding company structure that has been imposed upon it through the Transaction. The Company is therefore entitled to damages for these breaches of fiduciary duty.

COUNT II

DIRECT AND DERIVATIVE CLAIM FOR BREACH OF FIDUCIARY DUTY AGAINST LODZINSKI IN HIS CAPACITY AS AN OFFICER

182. Plaintiff repeats and realleges each and every allegation above as if set forth in full herein.

183. As explained herein, in addition to serving as a member of the Board, Defendant Lodzinski was also an officer of Earthstone at all times relevant to this action. As an Earthstone officer, Lodzinski owed the Company and the Class the utmost fiduciary duties of loyalty, good faith and due care.

184. For his own personal benefit and in breach of his fiduciary duties as an Earthstone officer, Lodzinski devised and orchestrated the unfair and self-dealing Transaction. Among other things, Lodzinski (a) devised the grossly unfair Transaction; (b) secured lucrative post-closing employment; (c) prevented the Board and the Special Committee from negotiating at arm's-length with Bold; (d) exploited his control over the Company to steer the Company into the grossly unfair Transaction; and (e) failed to secure fair value for the Class.

185. As a result of Lodzinski's breaches of fiduciary duty, the members of the Class have been harmed by having their economic and voting power in the company unfairly reduced vis-à-vis the Control Group Defendants. Plaintiff and the Class have no adequate remedy at law for this harm.

186. As a result of Lodzinski's breaches of fiduciary duty, the Company has been harmed as a result of the overpayment to EnCap and Bold. The Company has further been harmed by the new detrimental holding company structure that has been imposed upon it through the Transaction. The Company is therefore entitled to damages for these breaches of fiduciary duty.

COUNT III
DIRECT AND DERIVATIVE CLAIM
FOR BREACH OF FIDUCIARY DUTY
AGAINST THE CONTROL GROUP DEFENDANTS
AS CONTROLLING STOCKHOLDERS

187. Plaintiff repeats and realleges each and every allegation above as if set forth in full herein.

188. As explained herein, the Control Group Defendants were Earthstone's controlling stockholders at all times relevant to this action. As controlling stockholders, the Control Group Defendants owed the Company and the Class the utmost fiduciary duties of due care, good faith and loyalty. Those duties required the Control Group Defendants to place the interests of Earthstone's public stockholders above the Control Group Defendants' own interests.

189. For their own personal benefit and in breach of their fiduciary duties, the Control Group Defendants devised and orchestrated the unfair and self-dealing Transaction. Among other things, the Control Group Defendants (a) devised the grossly unfair Transaction, which would provide them with a bailout of its Bold investment; (b) prevented the Board and the Special Committee from negotiating at arm's-length with Bold; and (c) exploited their control over the Company to steer the Company into the grossly unfair Transaction.

190. As a result of the Control Group Defendants' breaches of fiduciary duty, the members of the Class have been harmed by having their economic and

voting power in the company unfairly reduced vis-à-vis the Control Group Defendants. Plaintiff and the Class have no adequate remedy at law for this harm.

191. As a result of the Control Group Defendants' breaches of fiduciary duty, the Company has been harmed as a result of the overpayment to EnCap and Bold. The Company has further been harmed by the new detrimental holding company structure that has been imposed upon it through the Transaction. The Company is therefore entitled to damages for these breaches of fiduciary duty.

COUNT IV

DIRECT AND DERIVATIVE CLAIM AGAINST THE BOLD DEFENDANTS FOR AIDING AND ABETTING THE CONTROL GROUP DEFENDANTS' AND DIRECTOR DEFENDANTS' BREACHES OF FIDUCIARY DUTY

192. Plaintiff repeats and realleges each and every allegation above as if set forth in full herein.

193. Each of the Bold Defendants knowingly participated in breaches of fiduciary duty by other defendants and thus is liable for aiding and abetting such breaches.

194. As explained herein, the Control Group Defendants and Director Defendants breached their fiduciary duties in connection with the Transaction.

195. Through their affiliation with directors on the Board and among the Control Group Defendants, the Bold Defendants knowingly solicited, encouraged

and/or participated in the unfair Transaction.

196. Thus, through their own efforts and those of their affiliates, the Bold Defendants caused and aided the Control Group Defendants and Director Defendants to breach their fiduciary duties in connection with the Transaction.

COUNT V

DIRECT AND DERIVATIVE CLAIM AGAINST THE CONTROL GROUP DEFENDANTS FOR AIDING AND ABETTING THE DIRECTOR DEFENDANTS' BREACHES OF FIDUCIARY DUTY

197. Plaintiff repeats and realleges each and every allegation above as if set forth in full herein.

198. In the alternative to Count III above, to the extent any or all of the defendants comprising the Control Group Defendants (as defined herein) are determined not to have owed direct fiduciary duties of care and loyalty to Earthstone's stockholders, each of these defendants knowingly participated in breaches of fiduciary duty by other defendants and thus is liable for aiding and abetting such breaches.

199. As explained herein, the Director Defendants breached their fiduciary duties in approving the Transaction.

200. Through their representatives on the Board, and through their affiliation with other directors on the Board, the Control Group Defendants knowingly solicited, encouraged and/or participated in the unfair Transaction.

201. Thus, through their own efforts and those of their representatives and affiliates, the Control Group Defendants caused and aided the Director Defendants to breach their fiduciary duties in approving the Transaction.

V. RELIEF REQUESTED

WHEREFORE, Plaintiff, on behalf of himself and on behalf of the Class, prays for judgment as follows:

- A. Declaring that this action is properly maintainable as a class action;
- B. Finding the Director Defendants liable for breaching their fiduciary duties owed to the Class;
- C. Finding that demand on the Earthstone Board is excused as futile;
- D. Finding that the Control Group Defendants breached their fiduciary duties in their capacities as the controlling stockholders of Earthstone;
- E. Finding that Lodzinski breached his fiduciary duties in his capacity as an officer of Earthstone;
- F. Finding the Bold Defendants liable for aiding and abetting breaches of fiduciary duty of the Control Group Defendants and Director Defendants;
- G. Finding the Control Group Defendants liable for aiding and abetting a breach of fiduciary duty by the Director Defendants;
- H. Awarding Plaintiff and the other members of the Class rescissory damages in an amount which may be proven at trial, together with interest thereon;

I. Awarding Plaintiff and the members of the Class compensatory damages in an amount which may be proven at trial, together with interest thereon;

J. Awarding Plaintiff and the members of the Class pre-judgment and post-judgment interest, as well as their reasonable attorneys' and experts' witness fees and other costs; and

K. Awarding such other and further relief as this Court may deem just and proper, including any extraordinary equitable relief as permitted by law or equity to attach, impound, or otherwise restrict Defendants' assets to assure Plaintiffs have an effective remedy.

Dated: June 7, 2017

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