

Recent Delaware decision imposes tougher standards for controlling stockholder freeze-out transactions

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What you need to know:

The Delaware Chancery Court's decision in *CNX Gas* heightens the standard for receiving business judgment review in a two-step tender offer and signals a unified approach to judicial review of going private transactions with controlling stockholders.

What you need to do:

Special committees of target boards should negotiate for broad mandates and authority similar to the authority of a full board in a third-party transaction. *CNX Gas* underscores the expectations that Delaware courts have for the authority and conduct of special committees.

In a recent decision by Delaware Vice Chancellor Laster in *In re CNX Gas Corp. Stockholders Litigation*, the Delaware Chancery Court again returned to the issue of the proper standard of review in a controlling stockholder freeze-out transaction. This decision, which has significant implications for the planning and structuring of controlling stockholder freeze-out transactions,

- imposes heightened requirements for controlling stockholders and boards of directors seeking to obtain the deferential "business judgment" standard of review of claims brought in connection with freeze-out transactions structured as two-step transactions (unilateral tender offer followed by a short-form merger);
- proposes a unified standard of review for all controlling stockholder going private transactions, regardless of whether the transactions are structured as long-form mergers or two-step transactions; and
- provides guidance regarding the expectations for special committee conduct and authority that is likely to result in an increase in the power and influence of special committees in these types of transactions.

The standard of legal review applicable to going private transactions with a controlling stockholder has been a significant and developing area of Delaware law over the past decade. Delaware courts have applied different standards of review depending on how the transactions were structured. Two-step tender offer transactions meeting certain procedural requirements have been entitled to review under the deferential "business judgment rule," while negotiated long-form merger transactions have been subject to the more stringent "entire fairness" standard of review. It is now apparent that, at least at the Chancery Court level, there is growing support for a single, consistent approach to review of freeze-out transaction. Applying the reasoning articulated by Vice Chancellor Strine in the 2005 case *In*

re Cox Communications, in which he proposed that the courts should have a “unified standard” of review of all controlling stockholder freeze-out transactions, Vice Chancellor Laster indicated that the business judgment standard of review should be applied to a controlling stockholder going private transaction, regardless of how it is structured, provided the transaction is both:

- negotiated and approved (or recommended) by a special committee of independent directors, and
- conditioned on the affirmative vote (or tender) of a majority-of-the-minority stockholders.

Applying this “unified” standard to the specific freeze-out transaction in *CNX Gas* (structured as a two-step tender offer), the court held that the transaction did not meet the requirement for business judgment review because, among other things, the transaction was not affirmatively recommended by a special committee of independent directors. This requirement that the special committee of the target’s board affirmatively recommend the tender goes beyond prior Delaware Chancery Court decisions, which applied the business judgment standard of review to certain two-step tender offers that were not affirmatively recommended by a special committee.

Going beyond the facts in the case in front of him, Vice Chancellor Laster took the opportunity to suggest that negotiated long-form mergers that meet the standards set out in *CNX Gas* should also avoid an entire fairness review and instead be entitled to the business judgment rule. In the court’s view, the same fundamental principles apply regardless of how the transaction is structured. Despite its broad language, however, the application of the unified standard suggested by *CNX Gas* to a long-form merger transaction would conflict with existing Delaware Supreme Court precedent. Consequently, as the *CNX Gas* court noted, only the Delaware Supreme Court can resolve this conflict.

The decision is also noteworthy for the guidance it provides regarding the scope of authority that a special committee should have in order to be considered properly constituted. The court noted with disapproval the fact that the special committee was not initially authorized to negotiate the offer and did not possess the full authority of the board of directors, which would include the ability adopt defensive measures and consider strategic alternatives. Though prior cases also had focused on the composition, mandate and conduct of special committees (including the independence of special committee members, the ability of a committee to retain separate advisors and the unfettered right to negotiate a transaction, including the right to “just say no”), the decision requires in clear terms that a special committee have the same authority the full board of directors would have in connection with a third party offer.

The standard of review under prior case law

A line of cases starting with the Delaware Supreme Court’s 1994 decision in *Kahn v. Lynch* held that a controlling stockholder going private transaction structured as a long-form merger was subject to the stringent entire fairness standard of review in any lawsuit challenging the transaction. Under this standard, the transaction must have both a fair process and result in a fair price, and the burden of proof is initially on the controlling stockholder and the target’s directors. The burden of proof may be shifted to the plaintiffs if there is either a properly formed and functioning independent special committee or a majority of the stockholders who are not affiliates of the controlling stockholder approve the transaction after full disclosure. By contrast, a line of cases starting with the 2001 *In re Siliconix* and the 2002 *Pure Resources* decisions held that the business judgment rule, rather than entire fairness review, would apply to a unilateral tender offer initiated by a controlling stockholder followed by a

short-form merger at the same price if the tender offer was non-coercive and minority stockholders received full disclosure. A tender offer would be deemed non-coercive if:

- it was subject to a non-waivable “majority-of-the-minority” condition,
- there was a commitment by the controlling stockholder to consummate a short-form merger promptly after the tender offer for the same price, and
- there were no retributive threats from the controlling stockholder.

Under this line of cases, there was no requirement for special committees to negotiate or affirmatively recommend the tender offer to the minority stockholders. The rationales provided for the lower standard of review in the two-step tender offer transactions included that:

- unlike mergers (where directors are required to determine that the merger is advisable and in the best interests of the stockholders), there is no statutory requirement for a target’s directors to take action in connection with a tender offer under the Delaware General Corporation Law, and
- a tender offeror has no duty to provide a fair price.

Since the *Pure Resources* decision, controlling stockholders have had an incentive to structure transactions as unilateral tender offers, rather than long-form mergers because they could lessen the role of a special committee or subsidiary board in connection with an offer, and the transaction would be subject to the deferential business judgment rule, provided there was a non-waivable “majority-of-the-minority” requirement.

In the 2005 *Cox Communications* decision, Vice Chancellor Strine (who also wrote the opinion in *Pure Resources* and noted the “discordance” in the two standards of review and its effects on structuring freeze-out transactions and related litigation strategy) suggested that the business judgment rule also should apply to any freeze-out transaction that is structured to mirror both elements of an arm’s length merger:

- approval (or recommendation) by active, independent and disinterested directors, and
- approval of (or tender by) a majority of disinterested stockholders.

Under such an approach, Vice Chancellor Strine observed, the controlling stockholder is effectively “standing only on one side of the transaction—as the buyer.” Thus, under the *Cox Communications* framework, the business judgment rule would apply to a freeze-out long-form merger if it were negotiated and approved by a special committee of independent directors and conditioned on an affirmative vote of a majority of the minority stockholders. If these requirements were not met, then the transaction would be reviewed for entire fairness. As the courts in both *Cox Communications* and *CNX Gas* observed, however, applying a “unified” standard in a long-form merger would likely conflict with the Supreme Court’s holding in *Kahn v. Lynch*, and only the Supreme Court could ultimately resolve this problem and provide definitive guidance.

Decision in CNX Gas

In *CNX Gas*, the court applied the *Cox Communications* framework to the analysis of a unilateral tender offer made by CNX’s controlling 83% stockholder, CONSOL Energy, Inc. CONSOL had authorized CNX to go public in 2005. Three years later, CONSOL decided to purchase CNX’s public shares and announced an exchange offer. When the market did not respond favorably, CONSOL withdrew its offer. In 2010, CONSOL decided to try again. The

transaction involved some important facts, including:

- there was a special committee, but it had only one member;
- the committee was initially authorized only to review and evaluate the tender offer (it was not authorized to negotiate it), prepare related disclosure in a Schedule 14D-9, and hire advisors;
- recognizing the poor response its prior offer had received from CNX's largest minority stockholder (affiliated funds holding 37% of the public shares), CONSOL decided to negotiate directly with the stockholder and ultimately entered into a tender agreement which required the stockholder to tender if the price was at or above a specified amount; and
- CNX's largest minority stockholder also held a comparable equity interest (and debt) of CONSOL, leaving it in a different position than CNX's other minority stockholders.

Importantly in terms of the special committee's mandate, the target's full board refused requests by the sole member to expand the committee's authority to include the full powers and authority of the board, to add an additional (new) independent director, to authorize it to consider other alternatives, and, until the day before the Schedule 14D-9 was due, to negotiate the terms.

After analyzing the prior case law, the *CNX Gas* court held that the business judgment rule should presumptively apply to any freeze-out transaction that meets both elements of an arm's length merger:

- negotiation and affirmative recommendation by a special committee of independent and disinterested directors, and
- a non-waivable condition requiring the approval of a "majority-of-the-minority" stockholders.

If these requirements are not met, the transaction would be reviewed under the entire fairness standard.

Applying this two-tiered test to the facts before it in *CNX Gas*, the court concluded that CONSOL's tender offer did not meet the standard for receiving business judgment review for three reasons. First, the special committee did not recommend the transaction. In fact, the committee cited its concerns about the process and its view that CONSOL was not willing to negotiate the price. The committee also cited as negative factors CONSOL's direct negotiations with the largest of the minority stockholders and the fact that the stockholder's interest "may not be the same as the other minority stockholders" of CNX because it also owned securities of CONSOL. Second, the court emphasized that the special committee had not been provided with authority comparable to what a board would possess in a third-party transaction. As indicated above, the CNX special committee initially was authorized only to review and evaluate the tender offer, prepare a Schedule 14D-9 reflecting the committee's position and engage financial advisors. The committee was not authorized to negotiate with CONSOL, to consider other alternatives or to respond effectively to block the offer by adopting a poison pill or other defensive measures.

As in other Delaware cases involving freeze-out transactions with a controlling stockholder, the court in *CNX Gas* was highly focused on making sure that the interests of the minority stockholders were aggressively protected. In particular, the *CNX Gas* decision discusses at some length the authority a special committee should have in order for the transaction to meet the standards necessary to have a transaction reviewed under the business judgment rule. In response to the defendant's claim that *Pure Resources* stood for the proposition that

the target's board had no obligation to adopt a rights plan, the court indicated that the special committee must have "authority comparable to what a board would possess in a third party transaction." The court noted that the *Pure Resources* decision had, "at that point in the evolution of the Siliconix standard," held that the target's board had no duty to block a tender offer through the use of a poison pill. The court also noted, however, that the Delaware Supreme Court had affirmed a post-*Pure Resources* decision where a target board had deployed a rights plan against a controlling stockholder. According to the *CNX Gas* court, "the shadow of pill adoption alone may be sufficient to prompt a controller to give a special committee more time to negotiate or evaluate how to proceed." While the court noted that a special committee would not have been *required* to use all of the power given to it to satisfy its fiduciary duties, the fact that a committee is deprived of the authority that a board would have in a third-party transaction was a basis for reviewing the transaction for entire fairness. The court indicated that "director primacy remains the centerpiece of Delaware law, even when a controlling stockholder is present." The court also questioned the principle, articulated in earlier decisions, that a subsidiary's board did not need to consider potential alternatives to a transaction with a controlling stockholder because the controlling stockholder could veto any such alternatives. As the court put it, "a controller does not have an inalienable right to usurp or restrict the authority of the subsidiary board of directors." The court noted that the reality that a subsidiary's alternatives might be limited does not mean that the controlling stockholder has "a veto over the board decision-making process."

Finally, the court expressed concerns about the legitimacy of the "majority-of-the-minority" condition because *CNX Gas*'s largest minority stockholder, which had entered into an agreement to tender its shares, also held equity and debt interests in *CNX Gas*'s controlling stockholder. This created a conflict between the interests of *CNX Gas*'s largest minority stockholder and the company's other minority stockholders. The court did not rule definitively on the effectiveness of the "majority-of-the-minority" condition, however, because the absence of special committee recommendation triggered the entire fairness standard in any event.

Going forward

As noted above, the Delaware Supreme Court holds the ultimate authority to determine whether the standards set forth in the *CNX Gas* case are applicable in freeze-out mergers for two-step tender offers. Even in the absence of such a decision, however, the *CNX Gas* case will have a number of practical implications that all parties to a controlling stockholder going private transaction should consider, including:

- **Replicate third-party negotiation.** The *CNX Gas* decision focused on whether the special committee approached a freeze-out transaction with its parent in the same way a full board would approach a third-party offer. Special committees should seek to replicate third-party negotiations and remain focused on the fundamental notion that, in the context of a freeze-out transaction, their fiduciary duties run to the public stockholders. To underscore this point, the court noted prior cases where committees had adopted rights plans and initiated litigation against controlling stockholders.
- **Create mandates which sufficiently empower special committees.** *CNX Gas* provided guidance on the requirements for an effectively constituted special committee by requiring that the power of the committee mirror that of the full board, including the power to negotiate with the controlling stockholder, to consider alternatives, to adopt defensive measures such as a poison pill or standstill and to commence litigation against the controlling stockholder, if necessary. The case makes clear that:

- the fact that the special committee's alternatives may be limited because of the controlling stockholder's ability to reject other deals does not mean it should not have the same power that the full board would have in a third-party transaction, and
- the fact that a special committee must have that power does not mean that it must exercise the power. As the court put it, "what matters is that the special committee fulfills its contextualized duty to obtain the best transaction reasonably available for the minority stockholders."

In addition to its importance in the context of whether the test for business judgment review is satisfied, it is likely that the guidance regarding the authority and role of a special committee set out in *CNX Gas* will also be influential in connection with a court's review of whether to shift the burden of proof to a plaintiff in connection with a transaction that is subject to the entire fairness standard.

- **Recommendation by special committee.** The court in *CNX Gas* held that, in order for a court to apply the business judgment rule to a special committee's decision in a two-step freeze-out transaction, the tender offer must be affirmatively recommended by the special committee. Having a special committee remain neutral is not sufficient. As a practical matter, this means that controlling stockholders must be prepared to negotiate and work with special committees if they wish to have the transaction reviewed under the business judgment rule.
- **Substance over form.** Although the Delaware Supreme Court may ultimately have the final word on the question, the lower courts in Delaware seem to be moving in the direction of a "unified" standard for the review of freeze-out transactions, as a result of which the substance of a transaction will be reviewed in the same way regardless whether it is structured as a two-step tender offer transaction or a long-form merger. As noted above, the level of authority and role of a special committee may be evaluated under a long-form merger under a *CNX Gas* standard by a court for purposes of determining whether to shift the burden of proving entire fairness.
- **Consideration of appropriate level of deal risk.** Controlling stockholders will need to consider whether the requirements for business judgment review (*i.e.*, both a fully authorized special committee *and* a majority of the minority vote or tender) are worth the attendant risk and delay to the transaction. Some may conclude that they will focus instead on ensuring that the price and process will withstand an entire fairness review and attempting to shift the burden of proof to a plaintiff (which under existing case law only requires *either* a properly functioning special committee *or* a "majority-of-the-minority" vote).
- **Challenges in determining what constitutes a "minority."** In determining which stockholders are to be included in the minority for purposes of a "majority-of-the-minority" vote, careful analysis should be undertaken to identify any factors that might suggest that certain stockholders have different interests from other stockholders and should, therefore, not be counted. Although the court in *CNX Gas* did not need to decide this issue given the other issues with the process and it noted that the case should not be read as encouraging "generalized fishing expeditions into stockholder motives," the language in the decision suggests that any stockholder with a potential conflict should be excluded from the majority of the minority calculation and analysis. This is particularly true when the controlling stockholder, as in *CNX Gas*, negotiates directly with a stockholder.

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