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Delaware Court Revisits Controlling Stockholder Freeze-Out Transactions

The Delaware Court of Chancery recently issued a significant decision in *In re CNX Gas Corp. Shareholders Litigation*, articulating a shift toward a "unified" standard of review for controlling stockholder freeze-out transactions. The court held that a freeze-out transaction structured as a tender offer should be reviewable under the deferential business judgment rule if it is (i) subject to a nonwaivable majority-of-the-minority tender condition and (ii) approved by a special committee that is empowered with the full authority of the board of directors. The court also suggested that, contrary to existing Delaware law, a freeze-out structured as a long-form merger should likewise be subject to the business judgment rule if it meets those standards. The decision is important for its attempt to reconcile competing Delaware cases in this area of law. Under the facts, however, the court held that the transaction would be reviewed under the stringent entire fairness test because the special committee did not recommend in favor of the tender offer and lacked negotiating authority. In addition, the court questioned the effectiveness of the majority-of-the-minority ("MOM") tender condition because one of the company's largest minority stockholders also owned shares of the controller.

Background

CNX Gas involved a go-private transaction initiated by a controlling stockholder that owned approximately 80 percent of the company's shares. The controller first approached another company stockholder, T. Rowe Price Associates, Inc. ("T. Rowe Price") about the freeze-out. With the approval of T. Rowe Price, which held 37 percent of the outstanding minority shares, the controller then publicly announced its offer to acquire all the outstanding minority shares at $38.25 per share, which represented a 45.8 percent premium. The tender offer obligated the controlling stockholder to commence a back-end merger promptly and at the same price as the tender. It was also subject to a nonwaivable MOM tender requirement.

The company's board consisted of four directors, three of whom were also officers of the controlling stockholder. The board thus authorized its sole independent member to form a special committee to review the transaction. The special committee hired independent financial and legal advisers, but it was not authorized to negotiate the terms of the freeze-out or explore alternative transactions. Ultimately, the special committee "determined not to express an opinion on the offer and to remain neutral," citing in the company's Schedule 14D-9 concerns about "the process by which [the controller] determined the offer price" and its view that the controller was unwilling to negotiate. It further cited the tender agreement with T. Rowe Price as a "potentially negative factor" with respect to the company's minority stockholders.

The *CNX* Decision

The *CNX* court began by stating that it was required to "weigh in" on the ongoing debate surrounding the proper standard of review of freeze-out transactions. Delaware courts currently treat such transactions differently depending on their structure. Under the Delaware Supreme Court's decision in *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110 (Del. 1994), a one-step transaction structured as a long-form merger is automatically subject to the stringent "entire fairness" test, which involves a judicial review for "fair price" and "fair dealing." The presence of a properly functioning special committee or a MOM voting condition will shift the burden of proof to the plaintiff, but it will not trigger the business judgment rule. Because "entire fairness" necessarily entails a factual inquiry into the merger, such claims cannot be dispensed with on

a motion to dismiss and, therefore, have significant "settlement value."

Under several Court of Chancery decisions, however, including *In re Siliconix Inc. S'holders Litig.*, 2001 WL 716787 (Del. Ch. June 19, 2001), and *In re Pure Resources, Inc. S'holder Litig.*, 808 A.2d 421 (Del. Ch. 2002), a two-step freeze-out structured as a tender offer followed by a short-form merger may be subject to the deferential business judgment rule, provided that (i) the offer was subject to a nonwaivable MOM tender condition, (ii) the controlling stockholder committed to consummate the back-end merger promptly and at the same price as the tender offer and (iii) the controlling stockholder refrained from making any retaliatory threats or disclosure violations. In addition, the company's independent directors must have had a sufficient opportunity to inform themselves and communicate with minority stockholders, but they are not necessarily required to recommend in favor of the offer. The *Siliconix* and *Pure Resources* opinions distinguished *Lynch Communication* on the theory that a tender offer is a voluntary transaction between stockholders and does not justify heightened judicial scrutiny where basic safeguards are in place. To date, the Delaware Supreme Court has not applied the *Pure Resources* standard or revisited its holding in *Lynch Communication*.

The *CNX* court opted for a "unified standard" in which all freeze-out transactions, whether structured as a merger or tender offer, should be subject to the business judgment rule if they are "both (i) negotiated and approved by a special committee of independent directors and (ii) conditioned on an affirmative vote of a majority of the minority stockholders." Like several recent commentators, the court questioned the logic of distinguishing between tender offers and long-form mergers, but opted for a more deferential approach that would encourage controlling stockholders to utilize MOM conditions and independent committees.

Turning to the facts of the case, however, the *CNX* court held that the proposed tender offer did not satisfy the conditions necessary for business judgment review. First, the special committee did not recommend in favor of the transaction. "That fact alone," the court stated, "is sufficient to end the analysis and impose an obligation on [the controlling stockholder] to pay a fair price." The court emphasized further that merely staying neutral is insufficient — the committee must affirmatively recommend in favor of the transaction. This was a departure from *Pure Resources*, which permitted a special committee to remain neutral.

Second, the special committee did not have authority to negotiate the transaction or consider other alternatives. The court stated that the committee needed authority "comparable to what a board would possess in a third-party transaction." It continued that such authority should include the power to deploy a stockholder rights plan (or poison pill) against the controlling stockholder. It explained that "director primacy remains the centerpiece of Delaware law" and "[a] controller making a tender offer does not have an inalienable right to usurp or restrict the authority of the subsidiary board of directors." The court concluded that "[b]ecause a board in a third-party transaction would have the power to respond effectively to a tender offer, including by deploying a rights plan, a subsidiary board should have the same power if the freeze-out is to receive business judgment review."

Finally, the court ruled that, on the preliminary record before it, the plaintiff had raised sufficient questions to undermine the efficacy of the MOM tender condition. Specifically, the court expressed concern over T. Rowe Price, which owed 6.3 percent of the subsidiary but also owned 6.5 percent of the controlling stockholder's outstanding shares. "Economic incentives matter," the court stated, and T. Rowe Price might have had "materially different incentives than a holder of CNX Gas common stock." This point was also made by the special committee in its Schedule 14D-9.

In light of the foregoing, the court concluded that the freeze-out was subject to the entire fairness standard. However, the court denied the plaintiff's request for a preliminary injunction to enjoin the tender offer. The court found that, because there were no disclosure violations or retributive threats, an injunction was unnecessary and that monetary damages would be available to the plaintiff class.

Implications

Doctrinal Shift

CNX signifies a continuing movement by Delaware courts to relax the standard of review applicable to controlling stockholder transactions. In 2005, Vice Chancellor Leo E. Strine, Jr., suggested in *In re Cox Communications, Inc. S'holders Litig.*, 879 A.2d (Del. Ch. 2005), that Delaware courts

unify their treatment of freeze-out mergers by moving toward the more deferential test set forth in *Pure Resources*. Several academics and practitioners have similarly argued that the entire fairness standard should be used more sparingly in reviewing controlling stockholder transactions. *CNX* joins this movement and adopted the "unified standard" set forth in *Cox Communications*, subject to certain safeguards.

The Delaware Supreme Court has not yet responded to these calls for unified treatment of controlling stockholder transactions. As it stands, *Pure Resources* and *Lynch Communication* dictate starkly different levels of judicial review for transactions with the same result: elimination of the minority stockholders' interest. It is possible, however, that even though Delaware's trial judges and most commentators favor a more deferential approach, the Delaware Supreme Court will continue to impose heightened scrutiny in long-form mergers and possibly tender offers too, thus overruling the *Siliconix*/*Pure Resources* line of cases. As *CNX* acknowledged, uncertainty in this area will remain until the Delaware Supreme Court has the chance to revisit it.

Special Committees

CNX set forth two important conditions for special committees that are necessary to trigger the business judgment rule: the special committee must (i) possess the full negotiating authority of the board of directors, including the power to consider alternatives and adopt a rights plan against the controlling stockholder, and (ii) affirmatively recommend the transaction to the minority stockholders. These requirements will significantly increase the leverage of special committees in negotiating a freeze-out. They also could potentially expose controlling stockholders to more viable "entire fairness" claims where a controller proceeds against the recommendation of a special committee or does not negotiate with it.

How these requirements will play out in practice is unclear. On the one hand, Delaware law permits a controlling stockholder to vote in self-interest and reject third-party proposals, thus limiting the ability of a special committee to consider and pursue other alternatives. Indeed, the *CNX* court recognized that "any effort to explore strategic alternatives likely would have been an exercise in futility." Thus, the use of a rights plan, for example, against a controlling stockholder may lead to a stalemate. On the other hand, the court stated that "[t]he fact that the subsidiary's alternatives may be limited as a practical matter does not require that the controller be given a veto over the board decision-making process." Thus, a special committee may have a difficult task in weighing the reality of the situation with "fulfill[ing] its contextualized duty to obtain the best transaction reasonably available *for the minority stockholders*."

Structuring Freeze-Out Transactions

Since *Pure Resources*, many controlling stockholders have structured freeze-outs as tender offers in order to gain the benefits of the business judgment rule. *CNX* adds the new requirements discussed above with respect to the special committee's role and power. This may cause some controlling stockholders to pursue long-form mergers and unilaterally approve the freeze-out by voting their own shares in favor of the transaction. The controller will owe a duty to pay a fair price to the minority stockholders and will likely draw litigation in an entire fairness proceeding, but this alternative may be more attractive than empowering a special committee with the power to adopt a rights plan and permitting minority stockholders to veto the transaction through a MOM condition. Establishing the entire fairness of a freeze-out where a controller's initial proposal was thwarted by a special committee may prove challenging. If, for example, the controlling stockholder removed the special committee members from the board in order to proceed with the freeze-out, it might undermine a showing of fair dealing.

Majority-of-the-Minority Approval Requirements

Finally, *CNX* is instructive on the issue of MOMs. In recent years, Delaware courts have held that a proper MOM must be nonwaivable. They have also held that the MOM must be based on the number of outstanding minority shares, not the shares actually voted. *CNX* goes further by examining the motives of minority stockholders, ruling that a MOM may not have been an adequate safeguard where a large minority holder's interests potentially diverged from those of other minority stockholders.

CNX emphasized that its holding was grounded on specific facts in the record — specifically, T. Rowe Price's dual stock ownership and the controlling stockholder's decision to negotiate with it and not the special committee. The court also cautioned that its holding would not require "generalized inquiries" or "fishing expeditions" into the motives of all stockholders.

Nevertheless, practitioners will need to be mindful of all potential conflicts going forward. Moreover, the court's logic could extend beyond MOM tender conditions and apply to any situation in which a cleansing stockholder vote is implemented. The court noted that "[e]conomic incentives matter, particularly for the effectiveness of a legitimizing mechanism like a majority-of-the-minority tender condition or a stockholder vote."

If you have questions about this decision or other matters of corporate law, please consult your Hunton & Williams LLP contact or Gary Thompson at (804) 788-8787, Roth Kehoe at (404) 888-4056 or Steven Haas at (804) 788-7217.

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