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Delaware Court of Chancery Revisits Standard for Going Private Transactions with Controlling Stockholders

In a May 25, 2010 decision, *In re CNX Gas Corporation Shareholders Litigation*, the Delaware Chancery Court raised the bar for controlling stockholders seeking to acquire a controlled subsidiary. Examining a two-step transaction (a unilateral tender offer followed by a short-form merger), the court held that the claims against controlling stockholders in connection with such acquisitions will be entitled to review under the deferential business judgment rule (as opposed to the stricter "entire fairness" standard) only if the offer both (1) is affirmatively recommended by an independent special committee that has been delegated full authority of the board with respect to the offer and (2) contains a satisfactory "majority-of-the-minority" condition. Contrary to long-standing Delaware Supreme Court precedent, the court also stated that, if these standards were satisfied, a going private transaction structured by a controlling stockholder as a long-form merger should also be subject to review under the business judgment rule. The decision has important implications for controlling stockholders and their advisors in structuring and carrying out going private transactions.

In an extended discussion of Delaware case law on controlling stockholder going private transactions, Vice Chancellor Laster rejected the pre-existing, judicially drawn distinction between a going private transaction structured as a long-form merger and one structured as a unilateral tender offer followed by a short-form merger. Under *Kahn v. Lynch*, the treatment of minority stockholders in a going private transaction effected through a long-form merger always is evaluated under the entire fairness standard, even if the merger terms were negotiated through a robust special committee process. By contrast, a second line of cases holds that a going private transaction structured as a unilateral tender offer by the controlling stockholder followed by a short-form merger is not subject to entire fairness review if it is non-coercive and minority stockholders receive full disclosure. The evolving criteria for a non-coercive tender offer were articulated in the *Pure Resources* decision: (1) the tender offer is subject to a non-waivable majority-of-the-minority condition, (2) the controlling stockholder commits to effect a short-form merger at the tender price promptly after the tender offer, and (3) the controlling stockholder makes no retributive threats. Having acknowledged the resulting "discordance between the treatment of similar transactions" in *Pure Resources*, Vice Chancellor Strine in *Cox Communications* proposed a "unified standard" for evaluating both types of transactions.

Vice Chancellor Laster acknowledged that only the Delaware Supreme Court ultimately can resolve the tension among the strands of case law. In the absence of such a resolution, however, the court determined that the *Cox Communications* standard is the "coherent and correct approach." Applying that "unified standard" in *CNX Gas*, the court held that CONSOL Energy, Inc.'s going private tender offer for the public shares of CNX Gas Corporation failed to qualify for business judgment review. The transaction was instead subject to the stringent standard of entire fairness to the minority stockholders.

CONSOL, together with its officers and directors and the officers and directors of CNX Gas, owned more than 80% of the CNX Gas common stock. Funds managed by T. Rowe Price were collectively CNX Gas's largest minority stockholder, owning approximately 37% of the publicly traded shares, or about 6.3% of the outstanding common stock. CONSOL entered into an agreement with T. Rowe Price in which T. Rowe Price agreed to tender its shares to CONSOL in connection with a tender offer for all CNX Gas's public shares. After the planned tender offer and the agreement with T. Rowe Price had been publicly announced, CNX Gas established a special committee, consisting of the board's only independent director, to review and evaluate the tender offer and to prepare related disclosure. The special committee was not given authority to negotiate the price of the tender offer or to consider alternatives.

CONSOL commenced the tender offer on April 28, 2010, and committed to effect a short-form merger at the tender offer price, promptly upon completion of the offer. The tender offer was made subject to a non-waivable condition that a majority of the outstanding minority shares be tendered. For this purpose, shares owned by directors or officers of CONSOL or CNX Gas were excluded, but shares owned by T. Rowe Price were included. Despite the limitations on its authority, the special committee sought a higher price from CONSOL, without success. In the Schedule 14D-9 filed by CNX Gas, the special committee remained neutral as to the offer, although the committee did receive an opinion from its financial advisor to the effect that the offered price was fair, from a financial point of view, to the minority stockholders.

Under the Vice Chancellor's analysis, the transaction process failed the two-pronged unified standard to qualify for business judgment review in several respects. Most importantly, the CNX Gas special committee did not affirmatively recommend the tender offer. Modifying slightly the *Cox Communications* standard, and analogizing to the requirement for affirmative board approval of a long-form merger, Vice Chancellor Laster held it was insufficient that the special committee remained neutral – to qualify for business judgment review, an affirmative recommendation of the special committee must be obtained. Although the absence of an affirmative recommendation was enough to trigger entire fairness review, the Vice Chancellor also noted the transaction failed to qualify for business judgment review in another respect since the delegation of authority to the CNX Gas special committee was limited. To be effective under the *CNX Gas* standard, a special committee must be "provided with authority comparable to what a board would possess in a third-party transaction." As described in the opinion, this authority should include not only

the right to negotiate price and consider other alternatives, but also to adopt a poison pill or take other action to "respond effectively" to the controlling stockholder's approach.

The court also expressed concern about the legitimacy of including T. Rowe Price in the "minority" for purposes of the majority-of-the-minority tender condition, noting that T. Rowe Price had "materially different incentives" from CNX Gas's other minority stockholders. T. Rowe Price owned approximately 6.5% of CONSOL's common stock, as well as interests in CONSOL debt. These holdings created a "direct economic conflict" between its interests and those of CNX Gas's other public stockholders. Since the transaction failed the first prong of the standard, however, the court did not need to (and did not) rule definitively on whether the majority-of-the-minority condition was ineffective.

The Delaware Supreme Court has not yet considered the "unified standard" set out in *CNX Gas* and until it issues a definitive decision on the subject, we believe that market participants likely will proceed on the basis that the *CNX Gas* standard applies to two-step going private transactions and may apply to going privates structured as long-form mergers. On that basis, the decision has a number of implications, including the following:

- *More demanding special committee process*. A controlling stockholder that wishes to benefit from business judgment review must be prepared to have the subsidiary's board delegate the board's full authority in respect of the offer to a special committee of independent directors, including the ability to adopt a poison pill to prevent the offer from being completed. In addition, the controlling stockholder must be prepared to make concessions if necessary to persuade the independent special committee to affirmatively recommend the offer. These requirements raise the potential cost of seeking to qualify for business judgment review, since they place more negotiating leverage in the hands of the special committee and may limit (or at best complicate) the ability of the controlling stockholder to acquire the minority shares over the objection of the special committee.

- *How to determine with confidence the composition of the "minority" for purposes of a majority of the minority condition?* Although Vice Chancellor Laster noted that the case should not "be read to encourage generalized fishing expeditions into stockholder motives," it is not clear what steps a special committee should undertake to minimize the risk of claims that the majority-of-the-minority condition was ineffective. For example, it would not be uncommon for institutional stockholders to have significant holdings of shares of both the subsidiary and the controlling stockholders and it is uncertain what diligence the special committee should undertake to determine and evaluate potential differing interests that might result from such holdings.

- *Structure of a going private proposal*. Since the *Pure Resources* decision, conventional wisdom has held that it may be preferable for a controlling stockholder to pursue a going private transaction via a unilateral tender offer rather than a long-form merger since (1) a tender structure would limit the ability of the subsidiary's board of directors to delay or

prevent a transaction that satisfied the majority-of-the-minority condition and (2) a long-form merger structure could never benefit from business judgment review. After *CNX Gas*, the relative risks and benefits of each transaction structure are more uncertain. Absent a Delaware Supreme Court ruling to the contrary, *CNX Gas* suggests that a long-form merger transaction might obtain deferential business judgment review, but only at the price of introducing a majority-of-the-minority condition. Conversely, given the *CNX Gas* requirement that the special committee be delegated the full authority of the board to respond to a unilateral tender offer, a two-step transaction no longer offers the same insulation against blocking action by the target's board of directors.

- *Will more controlling stockholders propose transactions subject to the "entire fairness" standard?* Given the costs and uncertainties imposed by the *CNX Gas* "unified standard" for business judgment review, it is possible that some controlling stockholders may decide to proceed with a transaction that will not benefit from business judgment review but that is designed to withstand an entire fairness review (*e.g.*, a tender offer at an attractive price that is not subject to a special committee recommendation but that complies with the *Pure Resources* criteria or a long-form merger subject to special committee approval but not a majority-of-the-minority condition).

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