

CNX Gas: Delaware Court Clarifies Standard Governing Controlling Stockholder Two-Step Freeze-out Transactions

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Introduction

On May 25, 2010, in *In re CNX Gas Corporation Shareholders Litigation*, Vice Chancellor Laster of the Delaware Court of Chancery endorsed a unified standard for reviewing controlling stockholder merger and two-step (tender offer followed by a short-form merger) freeze-out transactions, and arguably raised the bar for obtaining business judgment review in the context of a two-step tender offer by a controlling stockholder. Importantly, the Court held that a controlling stockholder two-step tender offer would be subject to business judgment review if the transaction is (i) negotiated and recommended by a special committee of independent directors, and (ii) conditioned on the tender of a majority of the shares held by unaffiliated stockholders. The *CNX Gas* decision provides much needed guidance to practitioners and controlling stockholders in structuring two-step tender offers in order to obtain the less stringent business judgment standard of review.

Background

The two-step freeze-out transaction at issue in *CNX Gas* involved an all-cash tender offer by CONSOL Energy, the owner of more than 80% of the outstanding shares of CNX Gas, to acquire all of the publicly-held shares of CNX Gas. Significantly, CONSOL negotiated an agreement with T. Rowe Price, the largest minority stockholder of CNX Gas holding 37% of CNX Gas's publicly-held shares through several of its funds, wherein T. Rowe Price agreed to tender its CNX Gas shares at a price of \$38.25 per share. The Court took special note of the fact that T. Rowe Price also held a substantial equity stake in CONSOL. In response to CONSOL's tender offer, CNX Gas formed a special committee comprised of the one independent outside director of CNX Gas. The special committee was authorized to evaluate the tender offer, engage financial advisors and legal counsel and prepare a Schedule 14D-9 solicitation/recommendation statement. However, the special committee was not granted the power to negotiate with CONSOL or consider other alternatives. In fact, the special committee's requests for expanded authority to consider other alternatives and to exercise the full powers of the CNX Gas Board were refused. When the special committee was ultimately granted "retroactive" authority to negotiate the tender offer price, CONSOL declined to increase the price. CNX Gas's Schedule 14D-9 prepared by the special committee did not express an opinion and remained neutral with respect to the tender offer, citing, among other things, concerns about the process by which the offer price was determined, CONSOL's unwillingness to negotiate, the refusal to grant full board powers to the special

committee and the tender agreement with T. Rowe Price that arguably increased the certainty of success of CONSOL's tender offer and reduced the negotiation leverage of the "majority-of-the-minority" condition. Plaintiff minority stockholders moved for a preliminary injunction against the transaction.

The Court Applies a Unified and Arguably Enhanced Standard of Review

After discussing the differing standards of review historically applied to negotiated mergers with controlling stockholders on the one hand (which have been reviewed under the stringent "entire fairness" standard, requiring defendants to establish fairness of both process and price), and a controlling stockholder's unilateral tender offer followed by a short-form merger on the other (which have been reviewed under an evolving, but often less onerous standard), the Court rejected notions that controlling stockholders never owe fiduciary duties when making tender offers, or that entire fairness analysis could not apply to a controlling stockholder tender offer that was the first step in a freeze-out transaction. The Court framed the key question as "[w]hat transactional structures result in the controlling stockholder not standing on both sides of a two-step freeze out?"

Vice Chancellor Laster cited favorably, and largely followed, the unified approach suggested by Vice Chancellor Strine in *Cox Communications*, which posited that business judgment review presumptively applies if a freeze-out merger is structured to mirror both elements of an arms-length merger, i.e., approval by both disinterested directors and disinterested stockholders. Thus, under *Cox Communications*, the business judgment standard of review presumptively applies if a freeze-out merger is both (1) negotiated and approved by a special committee of independent directors, and (2) conditioned on an affirmative vote of a majority of the minority stockholders. Similarly, if a first-step tender offer is both (1) negotiated and recommended by a special committee of independent directors and (2) conditioned on the affirmative tender of a majority of the minority shares, the business judgment standard of review presumptively applies to the freeze-out transaction. In both the merger and tender situations, if the two requirements are not met (or if a plaintiff can plead particularized facts sufficient to raise a litigable question about the effectiveness of one of the devices), the transaction would be reviewed for entire fairness. Vice Chancellor Laster, however, departed from this framework in an important respect: while *Cox Communications* might suggest that entire fairness would apply in the tender context only if the controlling stockholder proceeds when the special committee has recommended that the minority not tender, under Vice Chancellor Laster's *CNX Gas* formulation, "an affirmative recommendation is required for entire fairness not to apply." Thus, entire fairness review cannot be escaped where a special committee fails to take a position or offer a recommendation.

The Tender Offer Failed to Pass Muster Under the Unified Standard

Characterizing the unified standard applicable to merger and tender transactions as one in "which independent directors and unaffiliated stockholders are given the tools to negotiate with controllers, backstopped by meaningful judicial review for fairness when those tools are withheld", the Court found that the CONSOL tender offer did not pass muster and that the defendants must demonstrate entire fairness. First, the mere fact that the special committee did not recommend in favor of the transaction was sufficient to end the analysis and impose an obligation on the controlling stockholder to pay a fair price. Second, the special committee lacked authority comparable to what a board would possess in a third-party transaction; it was not authorized to negotiate or to consider other alternatives, and lacked the authority to deploy a rights plan, for example (although the Court stressed that a committee is not required to use that power). While the Court recognized that exploring strategic alternatives might have been a futility given the controlling stockholder's wishes, that was a decision for the special

committee and its advisors to make (and the Court suggested without elaboration, that aside from considering a rights plan, a special committee might resort to litigation as an option against a recalcitrant controlling stockholder).

Third, the Court found there were sufficient questions about the role of T. Rowe Price – the largest minority stockholder of *CNX Gas* – to undercut the effectiveness of the majority-of-the-minority tender condition. Noting that economic incentives matter in this context, the Court found that because T. Rowe Price held a slightly higher ownership percentage in CONSOL than it did in *CNX Gas*, it arguably had an incentive to favor CONSOL's tender offer. This became an issue in light of CONSOL's decision to "pre-negotiate" with T. Rowe Price. The Court did not rule definitively on the issue at this preliminary injunction stage, noting that defendants were free to argue later that the pre-negotiations were arms length and that the majority-of-the-minority condition was effective.

Because damages remain a viable remedy if defendants cannot demonstrate entire fairness, and because the Court found no merit in the separate disclosure claims advanced by plaintiffs, the Court declined to enjoin the tender offer, noting that the all-cash offer which was at a significant premium to *CNX Gas*'s price at the time, was not otherwise structurally or substantively coercive, and that no transactional alternative was identified.

Impact of the Decision

Under *CNX Gas*, the deferential business judgment rule presumption would only be available if the transaction is supported by an affirmative special committee recommendation, so a controlling stockholder will not be afforded such protection where a special committee remains neutral. Further, to attempt to achieve this protection, practitioners should consider a broad delegation of power to negotiate, consider strategic alternatives and employ rights plans and other measures available to a board. The opinion also signals that courts may look closer at specific minority stockholder incentives in assessing majority-of-the-minority provisions, both in the tender and merger contexts. On the other hand, *CNX Gas* provides further support that controlling stockholders may escape entire fairness review in the negotiated freeze-out merger context, if the controlling stockholder can establish that the transaction was negotiated and approved by an effective, independent and properly empowered special committee and conditioned on an affirmative vote of a majority-of-the-minority stockholders.



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