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Delaware Chancery Court Addresses Standards of Review in Controlling Stockholder Freezeouts

In *In re CNX Gas Corp. Shareholders Litigation*, C.A. No. 5377-VCL (Del. Ch. May 25, 2010), the Delaware Court of Chancery addressed the standard of review applicable to controlling stockholder freezeouts. Specifically, the Court held that entire fairness applies to a controlling stockholder freezeout tender offer unless the tender offer is (i) negotiated and affirmatively recommended by a special committee of independent directors *and* (ii) conditioned on the affirmative tender of a majority of the minority shares. This departs from the standard applied in other decisions by the Court of Chancery in cases such as *Siliconix*, *Aquila*, and *Pure Resources*. The *CNX Gas* decision also includes important commentary stating that the special committee must have authority comparable to what a board would possess in a third-party transaction, including the ability to deploy a rights plan, and that the effectiveness of a majority-of-the-minority condition may be undermined by the inclusion of stockholders whose economic incentives materially differ from those of the other minority stockholders.

In *CNX Gas*, CONSOL Energy sought to acquire all of the publicly held shares of its 80+% owned subsidiary, CNX Gas, in a tender offer. CONSOL first entered into and publicly announced an agreement with T. Rowe Price, the holder of 37% of CNX Gas's public float, in which T. Rowe Price agreed to tender its shares to CONSOL at a price of no less than $38.25. CONSOL's tender offer included a majority-of-the-minority condition, and CONSOL committed to promptly complete a short-form merger at that same price.

CNX Gas formed a special committee to respond to CONSOL's tender offer, but the special committee's authority was limited to engaging financial and legal advisors and preparing a Schedule 14D-9. The special committee was not formally authorized to negotiate with CONSOL or consider other alternatives, although it did attempt to negotiate an increased price without success. The special committee eventually issued a Schedule 14D-9 that remained neutral with respect to the tender offer.

The plaintiff minority stockholders sought to enjoin the transaction and argued that the tender offer should be reviewed for entire fairness. Under the Delaware Supreme Court's decision in *Kahn v. Lynch*, a negotiated merger between a controlling stockholder and its subsidiary is reviewed for entire fairness. But, the Delaware Court of Chancery has applied a less onerous standard when a controlling stockholder launches a tender offer followed by a short-form

merger. The standard applied to freezeout tender offers has been evolving, but the *Pure Resources* decision by Vice Chancellor Strine held that entire fairness should not apply if (i) the tender offer is subject to a non-waivable majority-of-the-minority tender condition, (ii) the controlling stockholder commits to consummate a prompt short-form merger at the same price, and (iii) the controlling stockholder has made no retributive threats. In *CNX Gas*, Vice Chancellor Laster proposed and applied an alternative "unified standard" for all freezeouts that is similar to the standard suggested in dicta in *Cox Communications*, another Vice Chancellor Strine opinion that was issued years after *Pure Resources*. As applied to freezeout tender offers, the unified standard provides that the business judgment rule would presumptively apply if the tender offer is (i) negotiated and affirmatively recommended by a special committee of independent directors and (ii) conditioned on the affirmative tender of a majority of the minority shares. The Court suggested that a similar standard should apply to negotiated controlling stockholder mergers, but that would require that the *Kahn v. Lynch* decision be overturned by the Delaware Supreme Court.

The Court applied its articulated standard to CONSOL's tender offer and found that entire fairness would apply for a number of reasons. Most obviously, the special committee did not recommend the transaction and it also lacked the authority to negotiate the transaction. The Court explained that in order for a freezeout transaction to receive business judgment review, the special committee must be provided with authority comparable to what a board would possess in a third-party transaction, including the ability to deploy a rights plan. Echoing concerns identified in the recent *EMAK* decisions, Vice Chancellor Laster also questioned the effectiveness of the majority-of-the-minority condition because it included T. Rowe Price, who held a slightly higher percentage of CONSOL stock than CNX Gas stock. The Court observed that T. Rowe Price's holdings arguably made it either indifferent to the tender offer or incentivized it to favor its holdings in CONSOL, and that economic incentives matter when the Court evaluates the effectiveness of a majority-of-the-minority condition. Having determined that entire fairness would apply and that the plaintiffs could seek an award of money damages after the tender offer closed, the Court declined to issue a preliminary injunction.

As a result of *CNX Gas*, controlling stockholders considering a freezeout must weigh the risk of entire fairness review against the transactional uncertainty introduced by empowering a special committee to negotiate the controlling stockholder's proposal.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to Stephen P. Lamb at (302) 655-4411, Robert B. Schumer at (212) 373-3097, or Frances F. Mi at (212) 373-3185.