WSGR ALERT

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THE LATEST WORD ON FREEZE-OUTS IN DELAWARE: *IN RE CNX GAS CORPORATION SHAREHOLDERS LITIGATION*

Since the Delaware Chancery Court's 2001 ruling in *In re Siliconix,*[1] the Delaware courts have applied different standards of legal review to acquisitions of a target company by a controlling stockholder[2] (commonly known as "freeze-outs") based on how the transaction is structured. Those structured as one-step freeze-out mergers are subject to review under an entire fairness standard. But freeze-outs that are structured as a tender offer followed by a short-form merger (or a "two-step transaction") will be evaluated under the more deferential business judgment rule standard, if they comply with a number of judicially imposed requirements elucidated in *Siliconix* and expanded in a series of subsequent cases.

The uneasy distinction between one-step and two-step freeze-outs grew more uncomfortable with the Delaware Chancery Court's May 25, 2010 ruling in *In re CNX Gas Corporation Shareholders Litigation*.[3] In *CNX*, Vice Chancellor Laster, the newest member of the Chancery Court, ruled that entire fairness was the appropriate standard for review of a two-step freeze-out by CONSOL Energy, the controlling stockholder of CNX, of the minority stockholders in CNX. However, Vice Chancellor Laster declined to issue a preliminary injunction against completion of CONSOL's first-step tender offer, finding that any harm to the plaintiffs could be remedied in a post-closing damages action. Vice Chancellor Laster's opinion endorses what he refers to as "the unified standard for reviewing controlling stockholder freeze-outs" previously proposed by Vice Chancellor Strine in *In re Cox Communications*[4] and urges the Delaware Supreme Court to resolve the "fundamental issues of Delaware law and public policy" raised by the disparate legal standards applied to one-step and two-step freeze-outs.

Evolution of the Current Standards Applied in Freeze-Out Cases

A brief review of relevant Delaware case law is in order. Since the Delaware Supreme Court's 1983 ruling in *Weinberger v. UOP. Inc.*,[5] the Delaware courts have applied an "entire fairness" standard of review to freeze-out transactions, under which two basic aspects of fairness, fair dealing and fair price, will be assessed to determine whether a transaction, viewed as a whole, is entirely fair. The *Weinberger* court, in a pointed footnote, observed that the use of an independent negotiating committee of outside directors to deal with the controlling stockholder at arm's length could have significantly impacted the court's view of fairness. The modern practice of using special committees to evaluate controlling stockholder transactions can be fairly attributed to this footnote. Subsequently, in *Kahn v. Lynch Communication Systems, Inc.*,[6] the Delaware Supreme Court clarified that, in a one-step merger, the use of a properly mandated independent special committee with the power to say "no" to the transaction, or a majority of the minority stockholder approval condition to the merger, would shift to a party challenging the fairness of a freeze-out transaction the burden of showing that the transaction was not entirely fair.

However, beginning with *Siliconix*, the Delaware Chancery Court has created a roadmap for structuring freeze-out transactions to avoid entire fairness review. Distinguishing a two-step tender offer and short-form merger from a one-step merger on the grounds that the tender offer was a "voluntary transaction" involving action by the stockholders of the target but requiring no action by the target's board of directors, the *Siliconix* court held that the entire fairness standard for freeze-out transactions established by the Delaware Supreme Court should not apply to a non-coercive tender offer by a controlling stockholder conditioned on the acquisition of at least 90 percent of the stock of the target where the acquiror disclosed an intention to effect a short-form

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[1] *In re Siliconix Inc. Shareholders Litigation*, No. Civ. A. 18700, 2001 WL 716787 (Del. Ch. June 19, 2001)

[2] In some situations, controlling stockholders can include entities that do not have majority voting control but still hold significant equity stakes in the target company in question. Counsel should be consulted in such situations.

[3] *In re CNX Gas Corporation Shareholders Litigation.* C.A. No. 5377 (Del. Ch. May 25, 2010)

[4] *In re Cox Communications, Inc. Shareholders Litigation*, 879 A.2d 604 (Del. Ch. 2005)

[5] 457 A. 2d 701 (Del. 1983)

[6] 638 A. 2d 1110 (Del. 1994)

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merger following completion of the offer. The following year, in *In re Aquila Inc. Shareholders Litigation,*[7] the Chancery Court declined to apply entire fairness review to a two-step freeze-out transaction in which the controlling stockholder made a non-coercive tender offer with a majority of the minority condition and committed to effect a short-form merger if the offer was successful.

The Chancery Court, in an opinion by Vice Chancellor Strine, refined its position on two-step freeze-outs in *In re Pure Resources.*[8] Although clearly uncomfortable with what he termed the "doctrinal tension" between the differing standards of review in one-step and two-step freeze-out deals, Vice Chancellor Strine opted in *Pure Resources* to follow the approach of *Siliconix* and *Aquila*, while expanding the requirements a two-step freeze-out must satisfy in order to fall under business judgment review.[9] Under Vice Chancellor Strine's formulation, (1) the tender offer must be subject to a non-waivable majority of the minority condition, (2) the controlling stockholder must commit to effect a short-form merger promptly after the tender offer at the same price, and (3) the controlling stockholder must not make any "retributive threats" in connection with the offer (in other words, the offer must be non-coercive). In addition, Vice Chancellor Strine required that the controlling stockholder (x) give independent directors free rein and adequate time to react to the offer by hiring their own advisers and providing a recommendation to the minority stockholders, and (y) disclose adequate information for the minority to make an informed decision.

Subsequently, in *Cox,* Vice Chancellor Strine gave free rein to his own misgivings about the "doctrinal tension" noted in *Pure Resources*. While ruling on an objection to counsel's request for attorneys' fees in connection with the settlement of litigation related to a one-step freeze-out, Vice Chancellor Strine took occasion to propose explicitly that the rule of *Lynch* be modified to afford a business judgment standard of review to one-step freeze-outs that replicate both elements of an arm's length process: negotiation and approval of the transaction by an independent special committee; and an informed majority of the minority vote. Judge Strine then went a step further, urging the adoption of a unified approach to one- and two-step freeze-outs that would permit application of the business judgment rule in either context. To achieve this, Judge Strine proposed a further expansion of the *Pure Resources* requirements for a two-step freeze-out, suggesting that, in addition to the requirements he had articulated in that case, *approval* of the controlling stockholder's offer by a special committee (as opposed to the committee providing a recommendation) should be required in order to invoke the business judgment rule.

The Background to CNX

CNX is a majority-owned subsidiary of CONSOL that is publicly traded as result of a carve-out IPO effected in 2005. By January 2008, CONSOL had decided to reacquire the public interest in CNX, and publicly announced an offer to exchange CONSOL shares for the public CNX shares. T. Rowe Price, the largest holder of CNX shares, reacted negatively to the offer. Although CNX formed a special committee to review the offer, CONSOL withdrew its proposal without formally commencing an exchange offer. In early 2009, CONSOL revamped the governance structure of CNX, reducing the number of directors with the eventual result that there was a single independent CNX director who was not also a CONSOL director. In September 2009, CONSOL approached T. Rowe Price about acquiring its CNX shares. Since T. Rowe Price remained the largest unaffiliated holder of CNX shares (T. Rowe funds held 6.3 percent of CNX, or 37 percent of the public shares, and also held about 6.5 percent of CONSOL's shares as well as CONSOL debt), and mindful of T. Rowe Price's prior objections, CONSOL recognized the need to secure T. Rowe Price's support in order to pursue a transaction. But after an initial conversation, discussions lay dormant for six months.

On March 9, 2010, discussions between CONSOL and T. Rowe Price were renewed at an investor conference, and the two sides exchanged views on pricing parameters. On March 15, CONSOL announced a significant acquisition of gas assets and publicly stated that it was considering, among other things, an acquisition of the public shares of CNX. On March 16, T. Rowe Price contacted CONSOL to schedule a meeting, which was set for March 19. T. Rowe Price e-mailed CONSOL management on March 17, proposing an exchange of CONSOL stock for T. Rowe Price's CNX shares at a $42.50 price with a small collar. At the March 19 meeting, the two sides exchanged views on valuation and exchanged a number of proposals, culminating in T. Rowe Price proposing a price of $38.25 in cash per CNX share. On March 21, the two sides entered into a tender agreement under which CONSOL agreed to commence a tender offer for all CNX shares at not less than $38.25 per share and T. Rowe Price committed to tender all of its CNX shares. CONSOL issued a press release announcing the agreement and the tender offer.

Following the press release, the sole independent director of CNX, John Pipski, requested that CNX form a special committee to consist of Pipski and another, new independent CNX director. On April 15, CNX formed a committee consisting solely of Pipski but did not act on his request to add a

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[7] 805 A. 2d 184 (Del. Ch. 2002)

[8] *In re Pure Resources Shareholders Litigation*, 808 A 2d. 421 (Del. Ch. 2002)

[9] Vice Chancellor Strine indicated that he believed tension between the approaches to one- and two-step freeze-outs was better resolved by relaxing the *Lynch* entire fairness rule to permit business judgment review of one-step freeze-outs involving appropriate protective features rather than subjecting two-step deals to the *Lynch* framework.

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new independent director. The committee was authorized to review and evaluate the offer, to prepare a Schedule 14D-9 solicitation/recommendation statement, and to engage legal and financial advisers. It was not authorized to negotiate or to consider alternatives, although Pipski requested authority to consider alternatives. After the April 15 meeting, Pipski hired advisers. The next day, he requested an expansion of the committee's authority, including "the full powers and authority of the board," which was also denied. On April 22, CONSOL provided the committee with financial information, including projections, and the committee's advisers subsequently met with both CONSOL management and T. Rowe Price. On May 5, despite not having technical authority to negotiate, but believing CONSOL was prepared to pay more, Pipski requested a price increase from $38.25 to $41.20 per share. On May 10, the day before the Schedule 14D-9 filing was due, the CNX board retroactively granted the committee authority to negotiate. On May 11, the parties held a conference call, but CONSOL declined to increase the offer price.

Later that day, the committee issued the Schedule 14D-9, taking no position with respect to the offer, but citing concern, among other things, about the process by which price was determined and about CONSOL's unwillingness to negotiate. The Schedule 14D-9 also cited the tender agreement with T. Rowe Price as a potentially negative factor, in that it increased the likelihood of the tender being successful and thus reduced the committee's leverage. In addition, the committee considered that T. Rowe Price could have different interests from other holders due to its ownership of CONSOL shares.

On May 25, Vice Chancellor Laster considered the plaintiffs' request for a preliminary injunction of the offer, scheduled to close on May 26.

Vice Chancellor Laster's Ruling

Vice Chancellor Laster denied the plaintiffs' request for a preliminary injunction against completion of CONSOL's tender offer, finding that the balance of hardships weighed in favor of allowing the tender offer to proceed. Vice Chancellor Laster reasoned that monetary damages were an adequate remedy should the court ultimately conclude that the plaintiffs were entitled to relief, and that there was no issue with regard to the ability of CONSOL to satisfy a monetary judgment. Moreover, in Vice Chancellor Laster's view, there was no evidence that the disclosures made by CONSOL in the tender offer contained any material misstatements or omissions.

More importantly, however, Vice Chancellor Laster concluded that the appropriate standard for review of the transaction was entire fairness. In his ruling, Vice Chancellor Laster echoed the concerns previously raised by Vice Chancellor Strine about the "doctrinal tension" in applying differing legal standards to forms of freeze-out transactions that achieve the same end result, ultimately concurring with Judge Strine that there is no basis in Delaware law preceding *Siliconix* for the view that controlling stockholders do not owe fiduciary duties in connection with a tender offer for the minority's shares.

Concluding that the unified approach advocated by Vice Chancellor Strine in *Cox* renders the standards for one- and two-step freeze-outs coherent by applying the business judgment rule to any freeze-out that is structured to mirror both elements of an arm's length merger by providing for disinterested director and shareholder approval, Vice Chancellor Laster declined to follow the *Pure Resources* test. Instead, Vice Chancellor Laster embraced the expansion proposed by Judge Strine in *Cox*, requiring that the special committee *affirmatively recommend* the controlling stockholder's proposal in order for a two-step freeze-out to be evaluated under the business judgment rule. Since the CNX committee had not recommended in favor of the CONSOL offer, the tender offer did not pass muster under the unified approach.

Vice Chancellor Laster's ultimate conclusion that entire fairness is the appropriate standard of review in *CNX* does not hinge solely upon an expansion of the procedural requirements for a two-step freeze-out from those articulated in *Pure Resources*. Vice Chancellor Laster's opinion identifies other defects in the process undertaken by CONSOL: the committee was not provided with authority comparable to what a board would possess in a third-party transaction, and questions about the role of T. Rowe Price undercut the effectiveness of the majority of the minority condition. The fact that T. Rowe Price funds held roughly equivalent equity interests in both CONSOL and CNX meant that it had "materially different incentives than a holder of CNX" stock. While acknowledging the complexity of assessing the financial incentives of a diversified group of funds such as T. Rowe Price, on the limited record before him, Vice Chancellor Laster was not persuaded that the negotiations with T. Rowe Price were fully arm's length.

Vice Chancellor Laster's opinion devotes considerable space to the question whether the special committee's authority should have included the ability to adopt a rights plan to exert leverage over CONSOL. In *Pure Resources*, Vice Chancellor Strine had declined to impose an obligation on the special committee to implement a rights plan in response to the controlling stockholder's tender offer, but left open the question whether the committee would have had the right to do so. In Vice Chancellor Laster's view, "[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." According to Vice Chancellor Laster, the fact that the committee was deprived of this authority provided a separate basis under *Cox* to review the CNX transaction for entire fairness.

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Conclusion

The Delaware Supreme Court has now received multiple invitations from the Chancery Court to resolve the tension between the legal standards applied in one-step and two-step freeze-outs. It remains unclear when the Delaware Supreme Court will have occasion to examine this issue. In the meantime, while the distinction between standards of review (and therefore legal risk) has incentivized controlling stockholders to avail themselves of the two-step process in a significant number of transactions, the trend of Delaware Chancery Court jurisprudence, from *Pure Resources* to *CNX*, has been to continue to enlarge the procedural hurdles in order to invoke business judgment review for two-step freeze-outs, and thus to reduce that incentive. As such, the benefits of the two-step approach are less clear. Moreover, in some cases the two-step process is not practicable, because the controlling stockholder is not entitled to make public disclosure of the subsidiary's material non-public information and therefore cannot make the disclosures required in a tender offer. For these reasons, the advisability of pursuing a tender offer and short-form merger, rather than a conventional one-step merger, to effect a freeze-out transaction, as well as the appropriate process and safeguards under each one in light of the evolving standards under Delaware law, should be carefully evaluated and discussed with outside counsel based upon the specific facts and circumstances.

For more information on this latest decision or any related matter, please contact Warren de Wied, David Berger, or Lawrence Chu in Wilson Sonsini Goodrich & Rosati's mergers and acquisitions practice.

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