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Practical Implications of CNX Gas on Controlling Shareholder Acquisitions

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The recent decision by Delaware Vice Chancellor Laster, *In re CNX Gas Corporation Shareholders Litigation*,[1] develops the "unified standard" for reviewing controlling shareholder freeze-out transactions. The unified standard provides that business judgment rule review is available for freeze-outs that are both: (1) negotiated and recommended by a special committee, and (2) "approved" by a majority of the minority shareholders. Delaware courts historically have applied different standards of review depending on whether the controlling shareholder freeze-out is structured as a negotiated merger or a unilateral tender offer. Negotiated mergers have been reviewed under an entire fairness doctrine. In contrast, unilateral tender offers have been able to obtain the benefits of the business judgment rule, albeit under an evolving set of procedures. If adopted by the Delaware Chancery Court for negotiated merger transactions and ultimately sanctioned by the Delaware Supreme Court, the unified standard would eliminate the dichotomy between controlling shareholder freeze-out deal structures and, if properly construed and applied, provide additional flexibility for transaction parties to obtain the benefits of business judgment rule review. CNX Gas marks another interesting and potentially important decision by Vice Chancellor Laster, currently in his first year on the bench, and suggests he is likely to continue to seek to shape Delaware corporate law in the future.

Background

CNX Gas involves the acquisition of CNX Gas Corporation (CNX) by CONSOL Energy, Inc. (CONSOL). Prior to the acquisition, CONSOL owned 83.5 percent of CNX's common stock and its representatives controlled the CNX board. In September 2009, CONSOL initially approached T. Rowe Price, which managed funds that owned 6.3 percent of CNX's common stock (as well as partially overlapping funds that owned 6.5 percent of CONSOL's common stock), about acquiring

[1] 2010 WL 2291842, Case No. 5377-VCL (Del. Ch. May 25, 2010).

the CNX shares held by the T. Rowe Price funds. In March 2010, T. Rowe Price reached an agreement to tender its CNX shares in a proposed CONSOL tender offer for all publicly held shares at $38.25 per share in cash.

After the announcement of T. Rowe Price's agreement, CNX's board approved the formation of a special committee consisting solely of John Pipski, CNX's lone independent director. The CNX board granted Pipski authority to prepare a Schedule 14D-9, hire legal and financial advisors, and make a recommendation as to the fairness of the transaction. Importantly, the special committee was not given authority to negotiate the terms of the tender offer, adopt a poison pill or consider other strategic alternatives.

CONSOL commenced its tender offer to acquire all publicly held shares of CNX in April 2010. Consummation of the tender offer was subject to a non-waivable condition that a majority of CNX's outstanding minority shares be tendered, excluding shares owned by the officers and directors of CONSOL or CNX, *but including shares held by T. Rowe Price*. Since T. Rowe Price had already agreed to tender its shares (which represented approximately 37 percent of the minority shares), the holders of only approximately 13 percent of CNX's other minority shares needed to tender to satisfy the majority of the minority condition.

Nearly a month after the CNX board formed the special committee and one day prior to the filing of the CNX Schedule 14D-9, the CNX board "retroactively" authorized the special committee to negotiate with CONSOL. The special committee's financial advisor opined that $38.25 was financially fair to CNX's minority shareholders, but Pipski and his advisors believed CONSOL was not offering as much as it was prepared to pay. The special committee sought to negotiate a higher price, but was unsuccessful.

The special committee determined not to recommend acceptance or rejection of the offer and to remain neutral because CONSOL had set the offer price during negotiations with T. Rowe Price, without input from the special committee or other minority shareholders, and because CONSOL had been unwilling to negotiate despite statements by CONSOL's management suggesting CNX's stock was worth more than $38.25 per share. The Schedule 14D-9 further identified the CNX board's refusal to give the special committee the full power of the board as an additional reason for neutrality.

The court then developed and articulated the unified standard, applied that standard to the facts of this unilateral tender offer freeze-out transaction, and held that neither requirement of the unified standard had been met. The court first notes that the special committee did not affirmatively recommend the transaction, so the first prong of the standard was not met. The court offered *dicta* regarding the scope of authority appropriate (or perhaps required) for a properly constituted special committee, noting that the special committee in this case was not initially empowered to negotiate with the controlling shareholder and did not otherwise have the full authority of the board with respect to the offer, including the ability to adopt a poison pill or pursue alternatives. Moreover, the court explained that, even though it might have been futile for the special committee to pursue alternatives without the controlling shareholder's approval, that judgment should have been left to the special committee, rather than CNX's conflicted board. Turning to the second prong, the court found that the majority of the minority condition was ineffective because T. Rowe Price's shares were counted as part of the minority for purposes of satisfying the condition, when T. Rowe Price funds had an economic interest on both sides of the transaction due to the significant ownership in CONSOL as well as CNX.[2] Accordingly, the court in effect treated T. Rowe Price as conflicted and, therefore, not part of the relevant "minority."

Practical Issues and Implications

As a strict legal matter, *CNX Gas* deals only with the standard of review in a unilateral tender offer freeze-out, as to which there is no Delaware Supreme Court precedent on point. If adopted by the Delaware Chancery Court for negotiated merger transactions and ultimately sanctioned by the Delaware Supreme Court, the unified standard articulated in *CNX Gas* would eliminate the dichotomy between the standards of review applied to different controlling shareholder freeze-out transaction structures and, if properly construed and applied, provide additional flexibility for transaction parties to obtain the benefits of business judgment rule review. In that regard, Vice Chancellor Laster's effort to unify substantively inconsistent review standards is laudable, and represents a positive step in the evolutionary process of Delaware law. That said, we believe important practical issues exist regarding the application of the unified standard and anticipate that the Delaware courts will refine and clarify certain aspects of the standard going forward.

Why the Standard of Review Matters

The standard of review applicable to a transaction has important practical implications for the cost and uncertainty associated with the fiduciary duty lawsuits that regularly arise in controlling shareholder freeze-out transactions.[3] Regardless of the real or perceived merits of these lawsuits, the standard of review that Delaware courts adopt impacts the stage at which a

[2] The court reached this conclusion solely by comparing T Rowe Price's percentage of ownership in both companies (6.5 percent vs. 6.3 percent), noting that because T. Rowe Price's funds in the aggregate held roughly equivalent equity stakes, T. Rowe Price was "fully hedged and indifferent to the allocation of value between CONSOL and CNX Gas." This analysis may be incomplete in looking only to simple relative percentage of ownership. For one, the shares were held in different funds managed by T. Rowe Price, so the analysis assumes that T. Rowe Price would sacrifice the interests of investors in some of its funds that held only CNX stock to benefit investors in other funds that held CONSOL stock and debt. In addition, other considerations may be relevant to assessing the relative interests of a shareholder with positions in two related companies, including that a transfer of value among the two entities does not necessarily translate into an equivalent transfer of value between shareholders of the two entities. For example, if CNX Gas generated far higher rates of return and growth than CONSOL, it might be far more productive economically for T. Rowe Price as a shareholder to extract the last cent from its higher growth investment before it was absorbed into its slower growth parent.

[3] The risk of an injunction also creates significant uncertainty in controlling shareholder freeze-out transactions, but this uncertainty exists regardless of the standard of review that is applied. As discussed in this Commentary, *CNX Gas* provides helpful clarification of the situations in which an injunction may issue in this context.

nonmeritorious lawsuit can be dismissed, as well as the substantive outcome if the case proceeds to trial.

Sophisticated transaction parties understand these dynamics and in structuring transactions subject to conflicts of interest seek to weigh (i) the potential under business judgment rule review to obtain dismissal of the lawsuit at an early stage, as well as the perceived benefits of the deferential standard at trial, which may reduce litigation-related costs and the risks of an adverse determination on the merits, against (ii) the cost and uncertainty of implementing the procedural protections that are required to achieve early dismissal or an advantaged procedural or substantive position at trial. Transaction parties evaluating these trade-offs generally consider the following practical issues:

- Entire fairness review, without burden shifting made available by appropriate procedural protections, carries substantial litigation risk for a controlling shareholder and all directors, and the prospect of personal liability for the conflicted directors.
- Affirmatively demonstrating entire fairness is factually intensive, making dismissal on the pleadings nearly impossible and greatly increasing the risk of protracted litigation and an adverse result.[4]
- Shifting the burden of proof to the plaintiffs in an entire fairness case[5] places a significant evidentiary burden on them and elevates their risks at trial, thereby frequently leading to a favorable settlement or trial outcome for the controlling shareholder.
- Burden shifting under the entire fairness doctrine rarely leads to pre-trial dismissal, however, adding to the settlement value for plaintiffs because defendants seek to avoid the costs of proceeding to a trial.
- Qualifying for business judgment rule review is far better for controlling shareholders than obtaining a burden shift under the entire fairness doctrine. It not only makes defense on the merits simpler, but also significantly increases the opportunity for a pre-trial dismissal, both of which contribute to optimize an inexpensive settlement.[6]

[4] *See, e.g., In re Cysive, Inc. Shareholders Litigation*, 836 A.2d 531 (Del. Ch. 2003); *Kahn v. Lynch Comm. Sys.*, 669 A.2d 79 (Del. 1995). In a rare decision, Chancellor Chandler recently dismissed on the pleadings an entire fairness case in which a company entered into a contract with its controlling shareholder. In reaching this conclusion, the court noted that while the plaintiff had plead unfair dealing it had not adequately plead facts regarding unfair price, which the court noted “is often the paramount consideration.” *Monroe County Employees’ Ret. Sys. v. Carlson*, 2010 WL 2376890 (Del. Ch. June 7, 2010).

[5] *See In re Cysive*, 836 A.2d 531; *Kahn*, 669 A.2d 79.

[6] *CNX Gas* indicates that the presumptions of the business judgment rule will not apply if a plaintiff can plead particularized facts sufficient to raise a litigable question about the effectiveness of one of the prongs. This would appear to open the door to factual disputes. However, by employing the stiffer particularized pleading standard applicable to fraud cases, as opposed to the looser notice pleading standard, the risk of spurious litigation proceeding past the motion to dismiss phase is greatly reduced.

Should Controlling Shareholders Seek the Benefits of the Unified Standard?

Understanding the implications of the standard of review, a controlling shareholder should consider whether the benefits of qualifying under the unified standard of *CNX Gas* outweigh the prospect of increased deal risk and increased transaction pricing created by the required procedural protections.

By empowering a special committee with authority to take defensive measures, such as adoption of a poison pill (or perhaps even a dilutive issuance[7]), the controlling shareholder surrenders its implicit threat of acquiring control directly from the shareholders if the special committee does not bargain "fairly" with the shareholder, which in our view could meaningfully affect the relative negotiating strength between the controlling shareholder and the special committee.

By agreeing to a non-waivable requirement that a majority of the disinterested shareholders approve the transaction, the controlling shareholder also risks that minority shareholders vote against the transaction in the hopes of obtaining a second bite at the control premium "apple." For this reason, the vote creates potential hold-up value for hedge funds and other short-term investors, including those that move into the stock post-announcement, to use a "vote no" threat or actual vote to create leverage for negotiation of a higher price.[8]

We expect controlling shareholders will evaluate the particular circumstances of their proposed transaction and the relationship with the independent directors, as well as the expected dynamics of the special committee process. They will weigh, in a concededly rough calculus, the expected cost savings in litigation or settlement obtained through adoption of a unified standard structure against the prospect of: (i) an overzealous special committee (or its advisors) using a broad grant of authority to effectively deprive the controlling shareholder of its control position and (ii) being held up by a relatively small proportion of shareholders. This analysis will require evaluation of both the company's shareholder profile and the expected market reception to the offered price. Of course, the decision as to deal structure and the authority of the special committee is not the controlling shareholder's or board's decision alone. We expect that future special committees may demand a broad grant of authority and a deal structure designed to obtain business judgment rule review, whether or not necessary or appropriate in the circumstances.

[7] *Mendel v. Carol*, 651 A.2d 297 (Del. Ch. 1994) (denying preliminary injunction where plaintiff asserted defendants breached their fiduciary duties by failing to grant an option to buy stock to dilute the voting power of an existing control block of stock).

[8] *LC Capital Master Fund, Ltd. v. James*, 990 A.2d 435, 451 (Del. Ch. 2010); *In re Lear Corp. S'holder Litig.*, 926 A.2d 94 (Del. Ch. Jun. 15, 2007).

Will Traditional *Kahn v. Lynch* Burden Shifting Survive Under the Unified Standard?

Our analysis of the choices available to a controlling shareholder presumes that the unified standard is, in effect, an "opt-in" structure. *CNX Gas* does not address whether the unified standard would merely sit on top of, or instead supersede, the traditional "burden shifting" standard developed 16 years ago by the Delaware Supreme Court in *Kahn v. Lynch*. However, in *Cox Communications*, the first case articulating a unified standard for reviewing interested transactions, the court explained that "*Lynch* in its current form could be retained to govern any merger in which the controller refuses to use both of these techniques from the inception of the process, allowing for the controller to proceed, get appropriate burden-shifting credit for use of special committee or a Minority Approval Condition, but remain subject to the entire fairness standard."[9] More recently, in *John Q Hammons Hotels*, the court noted the availability of the "burden shift" in the event a defendant could not demonstrate the transaction was subject to the business judgment rule.[10] Our view is that Delaware courts applying the unified standard in future cases should continue to recognize the availability of the burden shift if only one, but not both, prongs of the unified standard is satisfied. Retention of a one prong burden shift would allow transaction parties to "opt in" to the two prong unified standard if and when the perceived benefits of meeting both prongs exceed the perceived costs. We believe that this flexibility is important to avoid creating judicial review standards that disfavor controlling shareholder freezeouts to such a point that their value-creating opportunity for minority public shareholders is overwhelmed by the transactional risks imposed by the unified standard. Allowing the controlling shareholder and the special committee to determine a transaction's litigation risk is also consistent with the general interest and long standing Delaware philosophy of facilitating private ordering in the transactional context.

Does a Special Committee Need the Full Authority of the Board of a Non- Controlled Company?

CNX Gas contains a lengthy discussion of the authority proposed to be required for a special committee to be effective under the unified standard. This discussion indicates that a special 5 committee must have "authority comparable to what a board would possess in a third-party transaction."[11] This presumably would include the authority to:

- Engage legal and financial advisors
- Review and evaluate the proposed freeze-out transaction
- Negotiate the terms and conditions of the proposed freeze-out transaction with the controlling shareholder

[9] *In re Cox Communications Inc. S'holders Litig.*, 879 A.2d 604, 606 (Del. Ch. 2005).
[10] *In re John Q. Hammons Hotels Inc. Shareholder Litigation*, 2009 WL 3165613, at *14 n.48 (Del. Ch. Oct. 02, 2009).
[11] *CNX Gas*, 2010 WL 2291842, at *14. 7

- Consider and possibly pursue other alternatives to the proposed freeze-out transaction, including declining to change the status quo
- Adopt a poison pill or other defensive measures against the controlling shareholder to provide "time to respond, negotiate, and develop alternatives"
- File litigation against the controlling shareholder

Under prior Delaware precedent, the ability to negotiate at arms' length ultimately depended upon unfettered rights to engage disinterested advisors, negotiate at arms' length and "say no" to a transaction. Prior precedent has not required a special committee to have the authority of the board of a *non-controlled* company in a third party transaction.[12] Delaware law should (and in our view does) recognize the established economic rights of a controlling shareholder. Indeed, Delaware law traditionally has afforded wide discretion (subject, when applicable, to §203 of the DGCL) for a controlling shareholder to act in its own interests with respect to its stock, including the timing and nature of the sale of its stock or the purchase of additional shares, as long as the controlling shareholder does not "cause the corporation to effect a transaction that would benefit the [controlling shareholder] at the expense of the minority shareholders."[13]

To the extent *CNX Gas* sets a higher standard for the authority of a special committee, we believe the case only should be read to require the higher standard where transaction parties seek to obtain the benefits of the business judgment rule. Nonetheless, we expect that future special committees may demand a broad grant of authority to demonstrate their independence, even in the context of a *Lynch* burden-shifting structure, whether or not necessary or appropriate in the circumstances. Thus, controlling shareholders may find that the mandate of the special committee is the first negotiating hurdle in their freeze-out transaction process.

CNX Gas **Should Not Change the Liability Profile of Independent Directors of Controlled Companies**

We believe *CNX Gas* does not change the liability profile of independent and disinterested directors of controlled companies, whether serving on a special committee or otherwise, who are acting in good faith and on an informed basis, regardless of which standard of review is applied. Delaware courts routinely evaluate defendants differently depending on their position in the transaction. This is especially true in the case of independent members of the special committee who, by definition, do not have the divided loyalties of the interested directors or the controlling

[12] The logic of a requirement that a special committee have identical authority with the board of a non-controlled company would not only permit the committee to adopt a poison pill to block additional accumulations by the controlling shareholder, but also to prevent the controlling shareholder from selling its control position to a third party. Such authority has historically flowed only through §203 of the DGCL (subject to the limitations in that section), as to which a controlling shareholder could "opt out", at the formation of the company or prior to the time the company went public.

[13] *Gentile v. Rossette*, 906 A.2d 91, 103 (Del. 2006); *Dubroff v. Wren Holdings, LLC*, 2009 WL 1478697 (Del. Ch. May 22, 2009) (a controlling "shareholder is entitled to vote its shares as it chooses, including to further its own financial interest").

shareholder. In the oral argument on plaintiffs' motion for an interlocutory appeal in the *CNX Gas case*, Vice Chancellor Laster commended the actions of the special committee member, stating that "this is a fellow who, at least on a preliminary basis, performed quite well and should be, I think, not criticized for the fact that he was unable to ultimately get the price up."[14]

This is not to say that disinterested directors have a free pass for failing to exercise their duties of care and loyalty to public shareholders. If members of a special committee fail to act with due care (assuming such a claim is not exculpated) or with undivided loyalty to their public shareholder constituency, they can be subject to monetary liability.[15] However, disinterested members of a special committee should not be subject to heightened risk of liability or other special duties simply because of the related party nature of a freeze-out transaction. We do not view this as a controversial point, and believe that, to encourage independent directors to take on the issues, challenges and potential litigation risks associated with negotiating a freeze-out transaction with a controlling shareholder, courts reviewing freeze-out transactions should explicitly state that independent directors who discharge their duties of care and loyalty are not subject to liability.

***CNX Gas* Seeks to Limit the Potential Remedies in a Controlling Shareholder Going-Private Transaction**

CNX Gas articulates limited circumstances where the court would enjoin a controlling shareholder freeze-out transaction. The court specifically discussed the potential remedies under the unified standard, which by analogy may also be applicable to other controlling shareholder freeze-out transactions. Specifically, Vice Chancellor Laster asserts that an injunction may issue only:

- To address coercion by the controlling shareholder in a tender offer (which can be either structural if there is no commitment to a back-end merger or substantive)
- To address disclosure violations

Otherwise, the court holds that money damages would be available and deemed to be an adequate remedy if the price paid is not fair. The money damages claims would presumably be based on claims of: (i) breach of the duty of loyalty by directors who are affiliated with the controlling shareholder or are otherwise interested in the transaction and/or (ii) a breach of "duties" owed by a controlling shareholder to the minority shareholders in the going private transaction.

[14] Oral Arg. Tr. at 23, *In re CNX Gas Corp. Shareholders Litig.* (Del. Ch. May 26, 2010) (No. 5377-VCL).
[15] *In re Emerging Comm. Inc. S'holders Litig.*, 2004 WL 1305745 (Del. Ch. May 3, 2004) (holding directors liable in entire fairness case).