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Delaware Court of Chancery Announces New Rules for Controlling Shareholder Freeze-Out Transactions

*By Stephen A. Radin**

Delaware Vice Chancellor J. Travis Laster's recent decision in *In re CNX Gas Corp. Shareholders Litigation*, C.A. No. 5377 (Del. Ch. May 25, 2010), adopts new rules for Court of Chancery treatment of going private transactions that "freeze out" minority shareholders. These new rules create new and powerful incentives – and disincentives – for controlling shareholders and their advisors to consider in structuring going private transactions and balancing transaction certainty and litigation risk. These new rules also provide independent directors serving on special committees new leverage in their dealings with controlling shareholders. A request for an immediate appeal is pending.

Briefly, and as also summarized in the chart following this article:

- ***Going private transactions accomplished by tender offer followed by short-form merger***: Until *CNX*, there was no requirement that controlling shareholders offer minority shareholders a fair price in this form of transaction. *CNX* announces a fair price requirement – but provides business judgment rule protection *if both* the tender offer is approved by a special committee empowered as described below *and* a majority of minority shareholders tender.
- ***Going private transactions accomplished by one-step merger***: Delaware law before *CNX* requires that controlling shareholders offer minority shareholders a fair price in this form of transaction. *CNX* proposes (but does not yet explicitly adopt) the same possibility of business judgment rule protection for mergers that *CNX* provides tender offers – i.e., if the merger is approved by both a special committee empowered as described below and a majority of minority shareholders.
- ***Special committee empowerment***: In either case, the special committee must be granted the full power of the controlled corporation's board with respect to the transaction, including the power to negotiate, seek strategic alternatives, and, if the special committee deems it appropriate, deploy a "poison pill" rights plan against the controlling shareholder. *CNX* rejects prior Court of Chancery precedent to the contrary, and describes "director primacy" as "the centerpiece of Delaware law, even when a controlling stockholder is present."

While *CNX* is, of course, just one decision by one Court of Chancery judge, members of the Court of Chancery rarely decline to follow each other's decisions, and can be expected to adhere to the broad principles – if not all the details – stated in *CNX* until the Supreme Court speaks on these issues. The Supreme Court may or may not do so in the near future. If it does, it may or may not agree with the course the Court of Chancery has taken.

Going Private Before CNX

Until *CNX*, two separate lines of Delaware cases governed controlling shareholder freeze-outs, depending on the freeze-out mechanism involved. Cases such as *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110 (Del. 1994), governed

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going private transactions involving merger agreements, which require shareholder approval (a forgone conclusion where there is a majority shareholder). Cases such as *In re Siliconix Inc. Shareholders Litigation*, 2001 WL 716787 (Del. Ch. June 19, 2001), governed going private transactions involving tender offers followed by short form mergers (which allow the controlling shareholder to act without board approval if, following the tender offer, the controlling shareholder has reached 90% ownership).

Under *Lynch*, a 1994 Supreme Court decision, the merger price must be fair – and is tested in a court challenge by the entire fairness test, with the controlling shareholder bearing the burden of showing fair price and fair dealing. The business judgment rule, a presumption that directors are faithful to their fiduciary duties and pursuant to which a business judgment is upheld unless it cannot be attributed to a rational business purpose, never applies. The burden of proving fairness or unfairness may shift to the plaintiff *if either* the merger is approved by a special committee of disinterested and independent directors *or* by a majority of minority shareholders. The majority of the minority is based on all outstanding shares, not just shares that are voted, according to the Court of Chancery's 2009 decision in *In re John Q. Hammons Hotels Inc. Shareholder Litigation*, 2009 WL 3165613 (Del. Ch. Oct. 2, 2009).

Under *Siliconix*, a 2001 Delaware Court of Chancery decision, the tender offer and short-form merger price need not be fair – and, unlike a *Lynch* transaction, is not tested in court by the entire fairness test. Judicial relief requires false or misleading disclosure or wrongful coercion – i.e., conduct forcing shareholders to tender "for some reason other than the merits of the transaction" – and even then is typically limited to injunctive relief. (Appraisal also is available, but that alternative is typically disfavored by minority shareholders, because it cannot be pursued by class action and shareholders must forgo payment until the proceeding is complete and bear the risk of an appraised value below the transaction consideration.)

In re Pure Resources Shareholders Litigation, 808 A.2d 421 (Del. Ch. 2002), a 2002 Court of Chancery decision involving a tender offer and short-form merger, expanded *Siliconix*. Under *Pure*, a tender offer is coercive unless it includes (1) a non-waivable majority of the minority tender condition, (2) a promise of an immediate short-form merger at the same price offered in the tender offer if the tender offeror achieves 90% ownership, and (3) no threats of retribution (e.g., by seeking delisting) if the tender offer fails. The controlling shareholder also must allow independent directors sufficient time to retain financial and legal advisors, make a recommendation to minority shareholders, and provide minority shareholders the information they need to make an informed decision concerning the tender offer.

The New CNX Rule

The Court of Chancery's May 2010 decision in *CNX*, another case involving a tender offer and a short-form merger, questions the wisdom of different tests for different forms of freeze-outs, concluding that there is no good reason for different rules to govern economically similar transactions (a conclusion previously stated in *Pure*). The court in *CNX* determined to adopt a new "unified" rule first suggested by Vice Chancellor Leo E. Strine, Jr. in 2005 in dictum (in a decision on an attorneys' fee award dispute) in *In re Cox Communications, Inc. Shareholders Litigation*, 879 A.2d 604 (Del. Ch. 2005). The unified rule would govern both forms of freeze-outs – mergers and tender offers followed by short-form mergers.

Under the new *CNX* rule, going private transactions effectuated by tender offer, like going private transactions effectuated by merger in the past, must offer minority shareholders a fair price – and money damages may be sought where a shareholder believes the price is unfair. However, the business judgment rule will apply when the tender offer is conditioned on *both* the affirmative recommendation of a special committee *and* the approval of a majority of the unaffiliated shareholders. Also under the new *CNX* rule, special committee approval is effective only if the special committee is granted authority comparable to what a board would possess in a third-party transaction – including the power to negotiate, seek strategic alternatives, and deploy rights plans.

CNX is called a "unified" rule intended to "unify" the *Lynch* and *Siliconix* lines of cases, but *CNX*'s application in merger cases is uncertain: no such transaction was before the court in *CNX* and, even if it were, *Lynch* is a Supreme Court decision and the Court of Chancery cannot overrule the Supreme Court.

The new *CNX* rule is not good news for controlling shareholders seeking to effectuate going private transactions by tender offer. Under *CNX*, minority shareholders will have a legal right to a fair price enforceable in an action for money damages unless both special committee approval (with the committee empowered in a way special committees have not necessarily been empowered in the past) and majority of the minority approval are obtained. This right was triggered in the *CNX* case, because the special

committee in that case took no position on the tender offer and was not granted the required authority.

The new *CNX* rule, if ultimately adopted in the *Lynch* merger context, is better news for controlling shareholders seeking to effectuate going private transactions by one-step merger. Controlling shareholders under this scenario would have the option of structuring a freeze-out in a manner that would provide them business judgment rule protection rather than require them to prove entire fairness, as under *Lynch*. Controlling shareholders presumably no longer would have the option, as under *Lynch*, of shifting the burden of proving fairness (thus requiring plaintiffs to prove unfairness) by securing special committee or majority of the minority approval.

One final wrinkle about remedies. The new availability of money damages for unfairness in tender offer transactions provides shareholders a remedy that may make injunctive relief less likely in cases involving disclosure or coercion violations where there the controlling shareholder has the wherewithal to pay the potential damage award if the price is proven at trial to be unfair. The court in *CNX*, for example, stated its concern about the effectiveness of the majority of the minority tender condition in *CNX* and considered the possibility of an injunction requiring modification of the provision. The court concluded, however, that injunctive relief that might have been granted before *CNX* was unnecessary because the tender offer would be tested pursuant to the entire fairness standard and money damages would be awarded if the tender offer price was found to be unfair.

An Immediate Appeal?

On May 26, 2010, the plaintiffs in *CNX* sought immediate appellate review, and the Court of Chancery certified an appeal to the Supreme Court with respect to the appropriate standard of review. Vice Chancellor Laster readily agreed that "I absolutely believe that the Delaware Supreme Court needs to weigh in and decide *Siliconix* versus *Lynch* versus *Cox Communications*."

Plaintiffs withdrew their appeal, however, after the Court of Chancery declined to enjoin the transaction pending the appeal and ruled that a $15 million bond (5% of the court's estimate of the $300 million premium provided by the offer) would be required if the Supreme Court granted a stay pending the appeal.

On June 4, 2010, the controlling shareholder responded by seeking certification of its own immediate appeal, rather than face what it describes as "expensive and burdensome litigation that the trial court has decided at the outset will be resolved under the most plaintiff-friendly standard known to our law (entire fairness with no burden shift)." Neither Vice Chancellor Laster nor the Supreme Court has yet ruled on this application.

If an immediate appeal is denied, the case will proceed through discovery and a trial with respect to the fairness of the tender offer challenged in the case.

GOING PRIVATE TRANSACTIONS

	Pre-CNX	Post-CNX
Tender Offer/ Short-Form Merger	No duty to offer fair price, under *Siliconix* No need for business judgment rule protection Non-coercion requires ▪ non-waivable majority of the minority tender condition ▪ promise of short-form merger at same price as tender offer if 90% obtained ▪ no retributive threats ▪ controlling shareholder must allow special committee sufficient time to react to tender	Must offer fair price, under *CNX* Business judgment rule protection if both ▪ special committee approval and ▪ majority of minority approval Non-coercion requires ▪ non-waivable majority of the minority tender condition ▪ promise of short-form merger at same price as tender offer if 90% obtained ▪ no retributive threats ▪ controlling shareholder must allow special committee sufficient time to react to tender

	Pre-CNX	Post-CNX
Tender Offer/ Short-Form Merger *cont'd*	offer by hiring its own advisors, providing a recommendation to non-controlling shareholders and disclosing adequate information to allow non-controlling shareholders an opportunity for informed decision making No requirement that controlling shareholder give special committee all power board would have if dealing with third party offeror	offer by hiring its own advisors, providing a recommendation to non-controlling shareholders and disclosing adequate information to allow non-controlling shareholders an opportunity for informed decision making Controlling shareholder must give special committee all power board would have if dealing with third party offeror, including the power to negotiate, seek strategic alternatives, and, if the special committee deems it appropriate, deploy a "poison pill" rights plan against the controlling shareholder
One-Step Merger	Must offer fair price, under *Lynch* No business judgment rule protection Burden of proving fairness shifts if *either* ▪ special committee approval or ▪ majority of minority approval	If *Lynch* not overruled, same as pre-*CNX* one-step merger If *Lynch* overruled, same as post-*CNX* tender offer/short-form merger

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