

Minority Freeze-Out Transactions Revisited

Law360, New York (September 07, 2010) -- It is not uncommon for controlling stockholders of U.S. publicly listed corporations to engage in minority freeze-out transactions — that is, the acquisition by the controlling stockholder of the interest in the corporation held by the minority stockholders.

The acquisition is typically accomplished by either a one-step merger or a two-step transaction comprising a tender offer followed by a short-form merger once the controlling stockholder has acquired 90 percent of the target corporation.

Minority freeze-out transactions have been closely scrutinized by Delaware courts in light of the inherent conflict of interest between the controlling and minority stockholders in these transactions.

Delaware law has traditionally applied a different standard of review depending on how a controlling stockholder freeze-out is structured. Recent developments in the Delaware courts suggest a movement toward unification of the standard of review for minority freeze-outs, regardless of the structure of the transaction.

However, the Delaware Supreme Court has not yet opined on this matter. While awaiting clarity, it is important for controlling stockholders and special committees representing minority stockholders to follow traditional guideposts to ensure the protection of the business judgment rule.

Delaware Develops Competing Standards of Review for Minority Freeze-Outs

The Delaware Supreme Court's 1994 decision in *Kahn v. Lynch Communication Systems Inc.* established that "the exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness" and that "[t]he initial burden of establishing entire fairness rests upon the party who stands on both sides of the transaction."^[1]

Additionally, the *Kahn* court noted that the approval of such merger by an independent committee of directors or an informed majority of minority stockholders would shift the burden of proof on the issue of fairness to the plaintiff. As a practical matter, such shifting of the burden of proof is of significance in litigation and could be outcome determinative.

Post-*Kahn* rulings by the Delaware Court of Chancery, however, held that a controlling stockholder could avoid the entire fairness review of a negotiated merger in its entirety by launching a unilateral tender offer with the intention of subsequently consummating a short-form merger.^[2] *In re Siliconix Inc.*

Shareholders Litigation, decided in 2001, held that a tender offer is not subject to entire fairness review if it is non-coercive and without disclosure violations.[3]

In 2002, Vice Chancellor Leo E. Strine, in *In re Pure Resources Inc. Shareholders Litigation*, expanded on *Siliconix* in holding that minority squeeze out tender offers will be deemed “coercive” and subject to an entire fairness review unless: (i) the tender offer is subject to a non-waivable majority-of-the-minority tender condition; (ii) the controlling stockholder promises to consummate a prompt short form merger at the same price if it obtains more than 90 percent of the shares; and (iii) the controlling stockholder does not make retributive threats.[4]

Pure Resources also held that the controlling stockholder must allow the special committee of the target board “both free rein and adequate time to react to the tender offer[.]”[5]

Following *Siliconix* and *Pure Resources*, practitioners generally assumed that they could avoid the application of the entire fairness standard of review — and thus a lengthy and usually costly evidentiary hearing involving expert testimony — by effecting a freeze-out by means of a tender offer. Consistent with *Siliconix* and *Pure Resources*, practitioners also assumed that an actual recommendation of a special committee of the target corporation was not a prerequisite for avoiding entire fairness review.

In the years following *Pure Resources*, practitioners speculated that at some point the Delaware courts would reconcile the divergent doctrines for freeze-out mergers and tender offers. Commentators noted that such a dichotomy was difficult to intellectually reconcile, and effectively prioritized form over substance, without looking to the underlying intentions of the controlling stockholder.

Many practitioners held the view that a more consistent, uniform standard would allow a controlling stockholder effecting a freeze-out merger to avail itself of the benefits of the business judgment rule — instead of just the benefit of burden shifting within the entire fairness framework — as long as the transaction was approved by a majority of the minority stockholders. Such treatment would bridge the gap in the treatment of squeeze out mergers and tender offers.

In Re CNX Gas

Vice Chancellor Travis J. Laster, in *In re CNX Gas Corporation Shareholders Litigation*, offered a unified standard of review for controlling stockholder freeze-out transactions, whether by negotiated merger or unilateral tender offer.[6] However, Vice Chancellor Laster’s proposed standard would in effect make it more burdensome for controlling stockholders to accomplish a squeeze-out transaction via a tender offer than was the case previously.

In *CNX Gas*, the controlling stockholder, CONSOL Energy Inc., commenced a unilateral tender offer to acquire the outstanding public shares of *CNX Gas Corporation*. While the tender offer was subject to a majority-of-the-minority condition, CONSOL had, prior to launch of the tender offer, successfully negotiated with *CNX Gas*’s largest minority stockholder and secured such stockholder’s agreement to tender its shares.

The *CNX Gas* board subsequently formed a Special Committee, consisting of its sole independent director, to evaluate the proposed tender offer. The Special Committee was not authorized, however, to negotiate the terms of the tender offer or explore alternative transactions.

Notwithstanding its initial lack of authority,[7] the Special Committee sought to negotiate a higher price with CONSOL, believing that CONSOL was not offering the highest price it was willing to pay. When

these negotiations were unsuccessful, the Special Committee announced in a Schedule 14D-9 its neutral position with respect to the tender offer.

In order to adjudicate the claims before him, Vice Chancellor Laster had to determine the appropriate standard of review for a unilateral tender offer launched by a controlling stockholder seeking to consummate a short-form merger.

While noting that under Delaware law the standard of review for freeze-outs has traditionally turned on the manner in which the transaction is structured, Vice Chancellor Laster adopted a unified approach to evaluating such transactions, regardless of whether they are consummated by means of merger or tender offer.

Vice Chancellor Laster noted that in order to obtain the deference of the business judgment rule, a tender offer as the first step in a minority squeeze-out must be both (1) negotiated and recommended by a special committee of independent directors and (2) affirmatively tendered by a majority-of-the-minority. If both prongs are not met, then entire fairness review will attach.

Vice Chancellor Laster held that entire fairness review was triggered because the Special Committee of the CNX Gas Board declined to recommend that the minority stockholders tender their shares.

Vice Chancellor Laster acknowledged that his unified standard for review of tender offers conflicts with the decision in *In re Cox Radio Inc. Shareholders Litig.*, decided in the same month.

Cox Radio followed Pure Resources in holding that a two-step freeze-out is not subject to entire fairness if it is subject to a non-waivable majority-of-the-minority tender condition, the controlling stockholder makes no retributive threats and the special committee is free to evaluate the tender offer, provide fair disclosure and make an informed recommendation to the minority stockholders.[8]

Applying the business judgment rule, the court approved a class action settlement over plaintiffs' objection that the tender offer should be subject to entire fairness.

In his CNX Gas opinion, Vice Chancellor Laster invited guidance from above, as navigating the three divergent strains represented by Kahn, Pure Resources and now, CNX Gas, "implicates fundamental issues of Delaware law and public policy that only the Delaware Supreme Court can resolve." [9] However, the Delaware Supreme Court has thus far declined the opportunity to decide this issue, refusing interlocutory appeal pending final judgment in CNX Gas.

Expanded Requirements for the Special Committee's Authority

Vice Chancellor Laster's opinion in CNX Gas was also notable for its emphasis on the actual authority granted to the special committee first required by Pure Resources.

Though the fact that the Special Committee did not recommend the tender of minority stockholders alone was found to be sufficient to warrant entire fairness review, Vice Chancellor Laster also found that the CONSOL tender offer also did not pass muster under the unified standard because the Special Committee "was not provided with authority comparable to what a board would possess in a third-party transaction."

He suggests that under the unified standard a special committee must, at a minimum, be given full authority to explore strategic alternatives, file litigation against the controlling stockholder and implement a rights plan.

Vice Chancellor Laster applies the principle that the “central premise” of Delaware law is the vesting of “most managerial power over the corporation in the board, and not in the stockholders.”[10]

Notwithstanding the fact that its options may in practice be limited (such as by the unwillingness of the controlling stockholder to sell), a special committee, Vice Chancellor Laster believes, should have the same authority to negotiate with the controlling stockholder as would a board in a third-party transaction.

This prospect, however, will not be terribly appealing to a controlling stockholder, who could be at risk of having to give up control of the process to a minority group even though acquisition of the stockholder’s majority stake might have been obtained in exchange for payment of a control premium.

Process Guidelines

Until the Delaware Supreme Court offers further guidance on the standard of review for unilateral tender offers, the prudent approach is to structure a two-step freeze-out transaction with traditional safeguards in place.

Notwithstanding the recent CNX Gas decision, it is still possible to avoid the entire fairness standard of review and effectively manage liability risk for the controlling stockholder and the board of directors of the target corporation. In that regard, parties structuring freeze-out transactions should take the following steps:

Establish a Special Committee

The target must be given authority to establish an independent special committee of the board of directors to negotiate on behalf of the minority stockholders. Such committee should be given clear, broad powers at the outset of the process, which should include, among others, the power to review the proposal and actively negotiate with the controlling stockholder.

Condition the Transaction on the Approval of a Majority of the Minority Stockholders

The tender offer should be subject to a non-waivable condition that requires the tender of a majority of the shares held by the minority stockholders.

Follow the Tender Offer with a Prompt Short-Form Merger at the Same Price

The controlling stockholder must commit to follow the tender offer with a short-form merger (assuming the controlling stockholder then owns 90 percent of the stock of the corporation) and must commit to offer the same consideration in the second-step merger as was offered in the tender offer.

No Retributive Threats

The controlling stockholder must not threaten either the board of directors of the target (or any members or committees thereof) or any of the minority stockholders with retribution for a failure to recommend, approve, or tender into its transaction.

Make Accurate and Fulsome Disclosures

The disclosures to minority stockholders must contain all the information that a reasonable investor would consider important in tendering his stock, including the information necessary to make a reasoned decision whether to seek appraisal.

Negotiate with the Special Committee

The controlling stockholder should negotiate with the special committee and try to reach a deal that can be supported by it.

In the event that a recommendation cannot be obtained from the special committee, we believe that given the split among the Vice Chancellors and the lack of guidance from the Delaware Supreme Court on freeze-out tender offers, the controlling stockholder should still consider going directly to the minority stockholders.

In the end, assuming a large majority of the minority stockholders tender, we believe most members of the Chancery Court will be disinclined to require the transaction to be measured by entire fairness, assuming accurate and fulsome disclosures and the presence of traditional safeguards to protect minority stockholders.

The alternative, doing nothing or paying a price that is unattractive, would not seem to make good business sense to the controlling stockholder.

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The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media, publisher of Law360.

[1] Kahn v. Lynch Comm'n Sys. Inc., 638 A.2d 1110, 1117 (Del. 1994).

[2] See *In re Cox Radio Inc. S'holders Litig.*, No. CIV 4461-VCP, 2010 WL 1806616, at *11 (Del. Ch. May 6, 2010) (citing *In re Pure Res. Inc. S'holders Litig.*, 808 A.2d 421, 437 (Del. Ch. 2002) and rejecting application of Kahn in tender offers launched by controlling stockholders).

[3] No. CIV. A. 18700, 2001 WL 716787, at *6 (Del. Ch. June 21, 2001).

[4] 808 A.2d 421, 445 (Del. Ch. 2002).

[5] *Id.*

[6] *In re CNX Gas Corp. S'holders Litig.*, C.A. No. 5377-VCL (Del. Ch. May 25, 2010).

[7] The Special Committee's authority to negotiate was later retroactively granted by the CNX Gas board.

[8] See *Cox Radio*, No. CIV 4461-VCP, 2010 WL 1806616, at *11.

[9] CNX Gas Corp., C.A. No. 5377-VCL, at 28.

[10] *Id.* at 31 (citing *Hollinger Int'l v. Hollinger Int'l Inc.*, 858 A.2d 342, 387 (Del. Ch. 2004)).