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Putting the Chill on Freeze-Out Transactions

A recent Delaware Chancery Court decision creates uncertainty as to the applicable standard of judicial review for freeze-out transactions and the likely path and outcome of deal-related litigation.

A recent Delaware Chancery Court decision, *In re CNX Gas Corporation Shareholders Litigation*, has raised substantial doubts as to the applicable standard of judicial review for freeze-out transactions where a "controlling" parent seeks to acquire the shares held by the public minority. As a result of the decision, which appears in part to be inconsistent with other Delaware Chancery Court decisions and arguably Delaware Supreme Court precedent, parties structuring these transactions will face significant uncertainty as to the standard of judicial review and the likely path and outcome of deal-related litigation until the Delaware Supreme Court resolves this controversial issue.

In *CNX Gas*, Vice Chancellor Laster made a number of important rulings:

- The court, building on dicta from Vice Chancellor Strine in a 2005 case (*Cox Communications*), enunciated a new "unified standard" for review applicable to all freeze-out transactions—both one-step mergers and two-step transactions structured as a tender offer followed by a short-form merger (which we refer to as tender offers)—under which the transaction will be subject to the lesser business judgment rule standard rather than the entire fairness standard if the transaction is approved by (i) a properly empowered independent special committee of the subsidiary target's board of directors and (ii) a majority of the minority of unaffiliated, public stockholders. Under prior Delaware decisions, including an arguably controlling and inconsistent Delaware Supreme Court decision (*Kahn v Lynch*), a freeze-out merger was always subject to the entire fairness standard and use of procedural safeguards, such as a majority of the minority vote or a special committee, only served to shift the burden of proof regarding fairness from the subsidiary target to the plaintiffs alleging the unfairness of the transaction. On the other hand, under a string of prior Delaware Chancery Court decisions including *Siliconix* and *Pure Resources* (and a recent decision by Vice Chancellor Parsons in *Cox Radio*), a freeze-out tender offer was not subject to the entire fairness standard but the more deferential business judgment rule if (i) the transaction was reviewed by a properly functioning special committee of the subsidiary target's board, (ii) the tender offer included a non-waivable majority of the minority condition, (iii) the parent controller committed to execute a back-end merger at the tender offer price (which would be a short-form merger if the parent owned more than 90 percent of the target subsidiary's stock upon expiration of the tender offer), (iv) the transaction was non-coercive and (v) there were no material misstatements or omissions in the relevant disclosures.

- The court held that under this unified standard of review, in order for a freeze-out tender offer to be subject to the lower business judgment rule standard, the special committee must affirmatively approve the tender offer. Under prior Delaware decisions, a freeze-out tender offer was entitled to the more deferential business judgment rule as long as an independent special committee reviewed and considered the offer, even if it ultimately decided to take no position regarding (or, under certain precedent, even recommend against) the offer, and the other procedural safeguards identified above were implemented.

- Vice Chancellor Laster held that, in order to benefit from the lower business judgment rule standard, a special committee considering a freeze-out transaction should have the same rights a board would have in responding to an unsolicited third-party tender offer or acquisition proposal, including the right to explore strategic options, adopt a rights plan and institute litigation against the suitor. The court indicated that a special committee faced with a freeze-out transaction must be able to "fulfill[] its contextualized duty to obtain the best transaction reasonably available for the minority stockholders," including the right to explore strategic alternatives, even if doing so is an "exercise in futility" because the parent controller has already indicated it has no interest in any transaction other than the freeze-out.

- The decision interjected a new consideration into the determination of which stockholders should be considered "unaffiliated" for purposes of applying the majority of the minority condition by questioning whether stockholders of the subsidiary target who own equal or greater equity interests in the parent controller should be considered part of the unaffiliated minority.

The decision has important ramifications for Delaware transactional and litigation practice:

1. The decision eviscerates the principal benefit of a freeze-out structured as a tender offer, i.e., the ability of the parent controller to complete the transaction without being subject to the entire fairness standard even if the subsidiary target's special committee does not support the transaction. By comparison, under Delaware statutory law a freeze-out merger always requires the approval of the subsidiary target's board, acting through a special committee (unless the parent controller already owns 90 percent of the subsidiary's stock, in which case it can execute a short-form merger without the approval of the subsidiary's board or any of its stockholders). This holding would dramatically change the dynamics of negotiations between a parent controller and the special committee of the subsidiary target's board regarding the price and terms of the tender offer. To the extent the parent controller and the special committee are not able to reach agreement on the price and terms and the parent nevertheless proceeds with the tender offer, the fact that it will be subject to the entire fairness standard means shareholder litigation regarding the fairness of the transaction will be a virtual certainty and will be more difficult and costly to settle. For these reasons, this ruling may effectively mean that there will be no easy (and from the parent controller's perspective, no inexpensive and non-litigious) means of completing a freeze-out transaction.

2. It creates uncertainty with respect to the authority that must be delegated to a special committee in a freeze-out transaction. The decision does not explain what strategic options the special committee should be empowered to consider or why the committee needs the authority to explore strategic options if it can block a merger by not approving it and block a tender offer by adopting a rights plan. In addition, the decision does not explain why a special committee needs the authority to explore strategic options if doing so is futile because the parent controller has already indicated it will not agree to any such option.

3. In holding that the determination of which stockholders of the subsidiary target are unaffiliated for purposes of applying the majority of the minority condition should take into consideration whether the subsidiary target's stockholders also own shares of the parent controller, the court interjects a new, and arguably unworkable, consideration into the analysis. For example, because institutional stockholders often hold shares in street name, invest in various derivative securities and hedge long positions through offsetting short positions and other securities, it will often be impossible to reliably determine which minority stockholders of the subsidiary target actually have offsetting exposure to the parent controller's equity securities. It bears noting that the *CNX Gas* court emphasized that its views on this issue were affected by parent controller's extensive interaction with, and pre-tender commitments from, the dual stockholder.

   In *Cox Communications*, Vice Chancellor Strine, commenting on the *Pure Resources* string of tender offer cases and the arguable doctrinal inconsistency with the *Kahn* decision and other freeze-out merger cases, said:

   > "…the court decided that it was better to formulate protective standards that were more flexible, with the hope that at a later stage the two strands could be made more coherent, in a manner that addressed not only the need to protect minority stockholders but also the utility of providing a nonlitigious route to effecting transactions that often were economically efficient both for the minority who received a premium and in the sense of creating more rationally organized corporations."

   In *CNX Gas*, Vice Chancellor Laster apparently sought to resolve the inconsistent judicial treatment of two transaction structures that have the same economic and practical result, i.e., the cash out of minority stockholders at a specified price, by enunciating a unified approach for all freeze-out transactions. However, other Chancery Court decisions have identified this inconsistency and, in dicta, even proposed the solution adopted by Vice Chancellor Laster, but have decided to wait for a change in the applicable standards by (or at least guidance from) the Delaware Supreme Court. With the uncertainty created by apparent dueling

standards applied by different Chancery Court judges, the time is ripe for the Delaware Supreme Court to weigh in on this important issue so that dealmakers can structure freeze-out transactions with a greater degree of certainty as to the standard of judicial review that will be applied to the transaction and the path that deal-related litigation will likely take. Until the Delaware Supreme Court resolves this issue, there may be more, not less, litigation in freeze-out transactions, which could delay the closing of the transactions and result in higher settlement costs, potentially impacting the price paid for the minority shares in the deals.

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